

TRANSCRIPT OF RECORD.

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, APPELLANT,

vs.

**A. D. WATTS AND A. D. WATTS, AS COMMISSIONER OF
REVENUE OF THE STATE OF NORTH CAROLINA,
ET AL.**

**APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR
THE EASTERN DISTRICT OF NORTH CAROLINA.**

FILED DECEMBER 22, 1922.

(29,306)

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TRANSCRIPT OF RECORD.

In the District Court of the United States for the Eastern District of North Carolina.

At a District Court of the United States for the Eastern District of North Carolina begun and held at the court-house, in the city of Raleigh, on the fourth Monday after the fourth Monday in October, being the 20th day of November, in the year of our Lord one thousand nine hundred and twenty-two.

Present: The Honorable Henry G. Connor, Judge of the District Court for the Eastern District of North Carolina.

Among others were the following proceedings, to-wit:

In Equity.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Individually and as Commissioner of Revenue of North Carolina, et al.

Bill of Complaint.

Filed March 31, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. —.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al., Defendants.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

The Southern Railway Company, a corporation chartered and existing under and by virtue of the laws of the State of Virginia, and a resident of said State, brings this its bill of complaint against

A. D. Watts, individually, and as Commissioner of Revenue of the State of North Carolina, and a citizen of North Carolina, with his official residence at Raleigh, in the County of Wake,

State of North Carolina, in this judicial district of the United States; and James S. Manning, Attorney General of the State of North Carolina, and a citizen and resident of Raleigh in said state and district.

And respectfully shows the Court:

1. The Complainant is now, and was at all times hereinafter mentioned, a corporation of the State of Virginia engaged in the business of operating a railroad in said State and in the State of North Carolina, and also into and through the States of South Carolina, Georgia, Florida, Alabama, Mississippi, Tennessee, Kentucky, Indiana and Illinois, and the District of Columbia, and is now and was at all other times herein mentioned engaged in interstate commerce. The name, citizenship, and residence of the Defendants to this action is as above set forth.

2. This is a suit in equity and arises under the Constitution and Laws of the United States, as will presently more fully appear, and the amount involved in this suit, exclusive of interest and costs, is in excess of Three Thousand Dollars (\$3,000.00). The Complainant brings this suit to restrain the Defendants from levying,

4 assessing, and collecting certain income taxes from the Complainant and out of its property in North Carolina under color of the several statutes of North Carolina hereinafter mentioned. The Complainant respectfully shows that unless the Defendants and each of them be restrained from enforcing collection of said taxes, it will be deprived of privileges and immunities guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; and further that it will be deprived of its property without due process of law and will likewise be denied the equal protection of the law, in contravention of the Constitution of the United States and the Fourteenth Amendment thereof. The Complainant also shows that the taxes sought to be imposed by virtue and under the authority of the North Carolina statutes constitute a direct burden upon interstate commerce in violation of the Commerce Clause of the Federal Constitution.

3. The levy of an income tax in the State of North Carolina is authorized by Article 5, Section 3 of the Constitution of North Carolina, which is as follows:

"Sec. 3. Taxation Shall be by Uniform Rule and ad Valorem—Exemptions. Laws shall be passed taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock companies or otherwise; and, also, all real and personal property, according to its true value in money: Provided, notes, mortgages, and all other evidence of indebtedness given in good faith for the purchase price of a home, when said purchase price does not exceed three thousand dollars, and said notes, mortgages, and other evidence of indebtedness shall be made to run for not less than five nor more than twenty years, shall be exempt from taxation of every kind; Provided, that the interest carried by such notes and mortgages shall not exceed five and one-half per cent. The general assembly may also tax trades, professions, franchises, and incomes

"Provided, the rate of tax on income shall not in any case exceed six per cent (6%), and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes, to-wit: for a married man with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000; to all other persons not less than \$1,000, and there may be allowed other deductions (not including living expenses) so that only net incomes are taxed.'"

4. The Legislature of North Carolina at its regular session of 1921 enacted an income tax law as a part of the Revenue Act of 1921, being Chapter 34 of the Public Laws of North Carolina of 1921. This Act will hereinafter be referred to as The Income Tax Act of 1921.

5. The Complainant refers to and sets forth the following sections of The Income Tax Act of 1921, as amended by the General Assembly of North Carolina, Special Session of 1921:

6 "Sec. 101. Purpose.—The general purpose of this act is to impose a tax, for the use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions here set out, collectible in the year 1922, and annually thereafter:

- (a) Of every citizen of the State;
- (b) Of every domestic corporation;
- (c) Of every foreign corporation and of every non-resident individual having a business or agency in this State, in proportion to the net income of such business or agency.

"Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply.

"The tax imposed upon the net income of corporations in this schedule is in addition to the tax imposed under Schedule C of this Act."

"Sec. 201. Corporations.—Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three per cent of the entire net income of such corporation as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules:

"In case of a company other than companies mentioned in the next succeeding section, deriving profits principally from the ownership, sale, or rental of real estate or from the manufacture, sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and

tangible personal property in this State on the date of the close of the fiscal year of such company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

"In case of a corporation deriving profits principally from the holding or sale of intangible property, such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State."

"Sec. 202. Railroads and Public Service Corporations.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission,

8 shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State, and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

9 Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Sec. 203. Such tax shall first be levied, collected, and paid in the year 1922, and with respect to the net income received during the calendar year 1921 and annually thereafter."

Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable, and penal institutions, pensions for Confederate soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Sec. 306. Deductions.—In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

"3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation, the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act; Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas well-, and other natural deposits, the cost of development, not otherwise determined), and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that rate shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis, and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall at any time deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment if such business or investment is in a State that levies a tax upon such net income. The deduction authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

"12. In the case of a non-resident individual, the deduction allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the

State shall be determined under rules and regulations prescribed by the State Tax Commission."

6. Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of The Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State, including an equal mileage proportion within the State of its interstate business, and from this gross revenue shall deduct the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of car hire.

"and the balance shall be deemed to be their net income taxable under this Act." There is attached hereto as Exhibit "A" and made a part hereof an exact copy of the form furnished to complainant by the Revenue Department of the State of North Carolina, with the blanks for the figures filled in by complainant in accordance with said Section 202. This exhibit shows that complainant would be required to pay under Section 202 a tax of \$71,522.06. The Standard Classification of Accounts promulgated by the Interstate Commerce Commission under the provisions of the Interstate Commerce Act directs that there be deducted by railroads engaged in interstate commerce from their operating income in order to arrive at net income the following deductions in addition to those set forth in Section 202:

Joint Facility Rents;
Rent for Leased Roads;
Miscellaneous Rents;

Miscellaneous Tax Accruals;
 Separately Operated Properties—Loss;
 Interest on Funded Debt;
 Interest on Unfunded Debt;
 Amortization of Discount on Funded Debt;
 Maintenance of Investment Organization;
 Income Transferred to Other Companies;
 Miscellaneous Income Charges;

There is attached hereto, marked Exhibit "B," a "Statement of income applicable to State of North Carolina for year ended December 31, 1921, according to the Classification of Accounts prescribed by the Interstate Commerce Commission." This exhibit shows that if the income tax had been levied on that basis, the amount due by

complainant would be \$16,641.73. There is attached hereto, marked Exhibit "C," a statement of certain further deductions under the Interstate Commerce Commission's Classification of Accounts which should be allowed before arriving at net income. The amounts shown on Exhibit "C" are by the Commission permitted to be charged to profit and loss and are so charged by complainant on its books, but they are none the less proper deductions before arriving at net income and the Commission so permits and the Internal Revenue Department of the United States Government so permits in arriving at net income to be taxed under the Federal Income Tax Law. These further deductions being made, it is shown that this complainant would be required to pay an income tax of \$13,703.95.

Complainant avers that the foregoing facts disclose, first, that the method of arriving at net income as set forth in Section 202 does not produce net income and hence violates Article 5, Section 3 of the Constitution of North Carolina and is contrary to Section 101 of the Income Tax Act of 1921, and is void and the enforcement of said void statute denies to complainant the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment to the Constitution of the United States; and, second, since the net income includes a proportion of

interstate revenue and Section 202 of The Income Tax Act does not permit deduction of all the items which the Interstate Commerce Commission's Classification of Accounts permits to be deducted, the result is that the tax is levied in part upon gross revenue derived from interstate commerce, and is, therefore, a direct burden upon interstate commerce contrary to the Commerce Clause of the Constitution of the United States.

(b) Section 202 permits only the deductions set forth in said section as shown in Exhibit "A," which is a copy of the tax return required by the State Department of Revenue, while under Section 306 of The Income Tax Act individuals and corporations, other than those referred to in Section 202, are permitted deductions set forth in twelve numbered paragraphs and as shown in Section 306 above. The non-allowance to complainant of such of said deductions as are

applicable to complainant and are allowed by the law to individuals and other corporations discriminates against complainant and renders the law invalid. For illustration, there is no reason in law why other corporations and individuals should be permitted, in computing net income, to deduct "rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity" (paragraph 2 of

18 Section 306) or "all interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of non-taxable securities" (paragraph 3 of Section 306), while railroads are not permitted such deductions. This is such an arbitrary and unreasonable classification and discrimination against complainant as to deny to complainant the equal protection of the laws in violation of the Fourteenth Amendment to the Constitution of the United States and in violation of the Uniformity Section of the Constitution of the State of North Carolina, and works to the actual damage of complainant, as is shown by Exhibit "B" hereto attached, in the sum of many thousands of dollars.

(c) Section 202 is void because it prescribes one method of ascertaining net income of a corporation engaged in the business of operating a railroad or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, and a different method is prescribed in said Act for such corporations who do not keep their records according to the Standard Classification of Accounts. This creates a discrimination against complainant, which does keep its records according to the Standard Classification of Accounts, in that other corporations in the same class but which do not keep their accounts according to the Standard Classification of the Interstate Commerce Commission pay less taxes than they would if they so kept their accounts. This classification is so unreasonable as to be arbitrary and it violates the Uniformity Section of the Constitution of North Carolina and violates the Fourteenth Amendment to the Constitution of the United States.

(d) Complainant shows that the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of complainant's property known as an ad valorem tax, which is based upon the whole property of complainant, tangible and intangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent on the same assessed value, and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied, and unless restrained the defendants in this action will undertake to collect, an additional tax characterized as an income tax of 3 per cent on complainant's net operating revenue, including revenue derived from interstate commerce, and complainant avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the States, because necessarily a tax of one-tenth of one per cent upon the tangible and

intangible property of this complainant and a tax of 3 per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and complainant shows that this scheme of taxation levies a tax and burden upon the interstate commerce of complainant and violates the Commerce Clause of the Constitution of the United States, Section 8, Article 1.

(c) Complainant further shows that the statutes imposing an income tax upon complainant are unconstitutional and void in that they are violative of the scheme of taxation created and made mandatory by the Constitution of North Carolina. That instrument provides a dual system of taxation, one set of taxes being leviable by the State and the other by the counties and other governmental subdivisions. The complainant, therefore, avers that the scheme of taxation brought about by the tax laws of North Carolina, whereby the State derives its entire revenue from taxes other than a tax on property is unwarranted by the Constitution of North Carolina, which by its mandate requires that all property shall bear its just proportion of the burden of taxation and that laws shall be passed taxing by uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies or otherwise, and also all real and personal property according to its true value in money (Article 5, Section 3) and the complainant shows that the North Carolina Legislature has no power to exempt a large class of property from liability to taxation for State purposes as is done by Section 3, Chapter 34, Public Laws of 1921, and recoup the loss of revenue thereby occasioned by taxes other than a tax on property. Such method or scheme of taxation is plainly at variance with that intended to be established by the Constitution of North Carolina, and consequently Section 202, which attempts to impose a part of this additional burden of taxation upon the complainant, is void, in that it violates the Constitution of North Carolina and denies the complainant the equal protection of the law and deprives the complainant of its property without due process of law in violation of the Fourteenth Amendment to the Constitution of the United States; and complainant further shows that the said scheme of taxation is unconstitutional and void in that the complainant is charged with an undue proportion of the burden of taxation than is warranted by the Constitution of North Carolina in that complainant is required by the tax laws of North Carolina to pay to counties, cities and towns and special tax districts large sums as taxes on the assessed value of its property, \$96,306,357.00, and in addition thereto a so-called franchise tax of one-tenth of one per cent on its assessed value of \$96,306,357.00 and the income tax of 3 per cent on its net operating revenue.

7. Complainant shows that the form for the income tax returns for the calendar year ended December 31, 1921, was received by complainant, which requires said return to be made in conformity with the provisions of Section 202 of The Income Tax

Act of 1921. The law would require complainant to file said return and to pay the full amount of the tax on or before the fifteenth day of March, 1922, but, due to the fact that an amendment to a bill then pending in the Federal Court for the Western District of North Carolina against the Commissioner of Revenue had set up the invalidity of the said income tax law, the Commissioner of Revenue of North Carolina has extended the time for the filing of said return, and at this date the court in that case has held that the income tax was not before it. Complainant will, therefore, unless protected by order of this court, have to file said return and make said payment of \$71,522.06, as shown by Exhibit "A" hereto attached, whereas its true tax should not be in excess of \$13,703.95, as shown by Exhibit "C" hereto attached, and unless defendants are restrained and enjoined from so doing, the Commissioner of Revenue will proceed, under Section 504, to issue an order directed to the Sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the complainant for the payment of the amount of said tax, with the added penalties, interest and cost of exacting the same, and the Sheriff is directed in said Section 504 to proceed in all respects and in the manner prescribed with respect to executions issued against property upon judgments of a court of record. Furthermore, the sale of said property may be for the added penalties, which are set forth in Section 600 of said Act, which is in part as follows:

"If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment."

The Attorney General is directed, in addition to other penalties, in sub-section 5 of Section 600, as follows:

"Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction."

and unless restrained will proceed against complainant as directed by said law, to the great damage and embarrassment of complainant. The lien created by said Act upon the property of complainant would be a cloud upon its property, and the enforcement of said tax by execution would interfere with the conduct of complainant's business as an interstate carrier.

Complainant further shows that the penalties prescribed as set forth above are excessive, unreasonable, oppressive and inequitable, and that it is a denial of due process of law for the said Act to impose such penalties upon the complainant, who is proceeding with

due diligence to have it judicially determined whether or not the said Act is valid, the complainant in good faith asserting that said Act is not valid. Complainant therefore avers that even though the said Act should finally be declared valid, such penalties should not be imposed upon complainant.

Complainant avers that it has made no tender of any tax to the Commissioner of Revenue because it is advised that Section 202 is the only section applicable to it, and inasmuch as Section 202 is for the reasons herein set out, believed to be void, no tender would be proper, and for the further reason that it is advised that Section 202 is mandatory and that the Commissioner of Revenue has not the right to accept payment on any basis other than that set forth in said Section 202, and it has not, therefore, done the vain act of making a tender, but it expresses a willingness, if any plan may be devised or

25 the State is willing to accept a payment of income tax on the basis herein averred to be correct, to immediately make payment thereof.

Wherefore and for as much as complainant is remediless in the premises according to the common law, and remediable only in equity, and that complainant may not suffer irreparable injury and damage and may be permitted to pursue and carry on its business without unlawful hindrance and destruction, and that the railroad by complainant operated in the State of North Carolina as aforesaid and its other property in the State may not be subjected to illegal liens and clouds, complainant prays for a writ of subpoena to issue against the defendants and each of them to appear and full and true answer make to this bill of complaint, but not under oath, answer under oath being hereby waived, and that said defendants and each of them be enjoined by final decree, and, meanwhile, by a preliminary injunction as follows, to-wit:

That said A. D. Watts, Commissioner of Revenue of North Carolina, be enjoined and restrained from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, which the said Income Tax Act of 1913 imposes upon the complainant or its property in the State of North Carolina.

26 That James S. Manning, as Attorney General of North Carolina, be enjoined and restrained from instituting or authorizing the institution of any suit or proceedings to collect the said tax or any penalties as provided in said Income Tax Act.

Complainant further prays that the tax statutes of North Carolina herein alleged to be unlawful be decreed by this court to be unconstitutional and invalid, and that no assessment for taxation be made against the complainant thereunder, and no tax be levied against or collected from the complainant thereunder, and that no penalties be inflicted upon the complainant under the said Act; and for all such other, further, general and special relief to which in equity it may be entitled.

This is the first application for injunction in this case.

S. R. PRINCE,
Solicitor for Complainant.

L. E. JEFFRIES,
MANLY, HENDREN & WOMBLE,
C. O. AMONETTE,
Of Counsel.

DISTRICT OF COLUMBIA,
City of Washington:

F. S. Wynn, being duly sworn, deposes and says that he is Vice President of the Southern Railway Company, the above-named complainant, which is a corporation; that he has read the foregoing bill of complaint and knows the contents thereof; that the same is true of his own knowledge, except as to matters therein stated on information and belief, and as to those matters he believes it to be true.

F. S. WYNN.

Subscribed and sworn to before me this 29th day of March, 1922.

[SEAL.]

HARRY K. PIMPER,
Notary Public, District of Columbia.

EXHIBIT A.

State Department of Revenue.

Public Service Corporation Income Tax Return (Railroads).

For Calendar Year Ending December 31, 1921.

Name: Southern Railway Company.

Business Address: 1300 Pennsylvania Avenue, N. W., Washington, D. C.

We, the undersigned, president and treasurer of the corporation in which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable year as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

President.

Treasurer.

Sworn to and subscribed before me this — day of —, 1922.

(Official capacity.)

*Net operating income (when business is wholly within the State).....	.....
*Net operating revenue, including equal mileage proportion within this State of the interstate business (when business is in part within and in part without the State).....	\$24,501,334.44	
Other income.....	.....
Total Income.....		\$24,501,334.44
*Operating expenses (when business is wholly within the State).....	.....
*Proportionate average of operating expenses (when business is in part within and in part without the State).....	\$20,144,997.18	
*Uncollectible revenue.....	14,882.50	
Taxes paid in this State, other than income and war profits and excess profits taxes.....	1,368,000.00	
Total deductions.....		21,527,879.68
Operating income, less deductions.....		\$2,973,454.76
Plus or Minus any credit or debit balance received or paid on account of car hire. And when any railroad is partly within and partly without the State then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid.....		589,386.60
Net taxable income.....		\$2,384,068.16
Tax at 3%.....		71,522.05
Main track mileage (system).....		6,971.86
Main track mileage (State, including trackage).....		1,219.30

EXHIBIT B.

Southern Railway Company.

Office of Comptroller.

Statement of Income Applicable to State of North Carolina for Year Ended December 31st, 1921, According to the Classification of Accounts Prescribed by the Interstate Commerce Commission.

I. Operating Income:

501. Railway Operating Revenues.....	\$24,501,334.44
531. Railway Operating Expenses.....	20,144,997.18
Net Revenue from Railway Operations	\$4,356,337.26
532. Railway Taxes Paid.....	1,368,000.00
533. Uncollectible Railway Revenues.....	14,882.50
Railway Operating Income.....	\$2,973,454.76

*As per standard Classification of Accounts of Interstate Commerce Commission.

II. Non-operating Income:

Equipment Rents (Accounts 503 to 507 and 536 to 540).....	*\$596,348.84
508. Joint Facility Rent Income.....	66,886.47
510. Miscellaneous Rent Income.....	46,122.71
511. Miscellaneous Non-operating Physical property	17,782.91
513. Divided Income.....	24,538.67
514. Income from Funded Securities.....	272,578.63
515. Income from Unfunded Securities and Accounts	166,488.54
519. Miscellaneous Income.....	13,791.04
Total Non-operating Income..	\$11,540.13
Gross Income.....	\$2,984,994.89

III. Deductions from Gross Income:

541. Joint Facility Rents.....	\$213,767.07
542. Rent for Leased Roads.....	591,491.75
543. Miscellaneous Rents.....	1,981.35
546. Interest on Funded Debt.....	1,481,391.58
547. Interest on Unfunded Debt.....	116,151.96
551. Miscellaneous Income Charges.....	25,486.77
Total D-ductions from gross Income	\$2,430,270.48
Net Income	\$554,724.41
Tax @ 3%.....	\$16,641.73

Washington, D. C., March 21st, 1922.

EXHIBIT C.

Southern Railway Company.

Office of Comptroller.

Statement of Amounts Deductible from Income Applicable to State of North Carolina for Year Ended December 31, 1921, Which Amounts According to the Classification of Accounts Prescribed by the Interstate Commerce Commission are Chargeable to Profit and Loss.

Discount extinguishable thru Surplus.....	\$71,728.88
Miscellaneous Debits	26,196.97

(Bad debts written off during the year accrued in North Carolina.)

This figure shows loss under said accounts.

Total Further Deductions.....	\$97,925.85
From Net Income as Shown by Exhibit B.....	554,724.41
Leaving Taxable Net Income to be.....	\$456,798.56
Tax at 3%.....	13,703.96

31 *Application for Interlocutory Injunction.*

Filed March 31st, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. —.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.

Comes the above named plaintiff and shows the court:

That it has instituted in this Court by bill of complaint an action against A. D. Watts, individually, and as Commissioner of Revenue of the State of North Carolina and against James S. Manning, Attorney General of said State, as shown in said bill which is now referred to and made a part of this application, the object and purpose of the action being to secure from this Honorable Court an order preliminarily and perpetually enjoining the defendants, who are charged with the duty of collecting income taxes under The Income Law of 1921 of North Carolina, from taking or causing to be taken any action toward enforcing the filing of a return of the collection of a tax or any part thereof under the said Income Tax Act of 1921, and from instituting or authorizing the institution of any suit or proceedings to collect the said tax or any penalties as provided in said Income Tax Act, on the ground that said income tax in the manner imposed upon petitioner is contrary to the Constitution and laws of North Carolina and the Constitution of the United States. The bill alleges and sets forth the grounds of unconstitutionality of the said income tax assessment and of the Income Tax Act of 1921 under which said invalid assessment was made and under which the illegal taxes will be collected by the defendants named in said bill unless restrained by this Honorable Court, all of which is more fully alleged, set out, and explained in the bill of complaint filed herein.

Under the provisions of the said Income Tax Act of 1921 of North Carolina, it is required that a return be filed on or before the 15th day of March, 1922, and that the tax shall be paid on or before the 15th day of March, 1922. Your petitioner, however, has secured an extension of sixty days as provided in said Act for the filing of a

return and payment of said tax. Unless the return is made and the tax is paid before the expiration of said sixty days, the amount of said income tax will be doubled, and such doubled tax will be increased by one per cent for each month or fraction of a month from the time the tax was originally due to the date of payment. Said extended period of sixty days will expire, said return and payment of the income tax will be due, and the collection thereof will be undertaken prior to the determination of this cause, unless the tax collecting officers are restrained.

Wherefore, application is made under Section 266 of the Judicial Code for an interlocutory injunction as prayed for in said bill, and this Court is petitioned to call to his assistance to hear and determine this application two other judges, and that the statutory notice of the hearing of this application be given the Governor and the Attorney General of the State of North Carolina and each of the defendants to the said bill, and an order issue requiring the defendants to show cause at the time and place to be fixed by this Court according to law why said interlocutory injunction should not issue as prayed for.

This application is based upon the verified bill of complaint on file herein.

S. R. PRINCE,
Solicitor for Complainant.

Order on Application for Interlocutory Injunction.

Filed April 10, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.

The application for an interlocutory injunction was presented to me this — day of March, 1922; and having read and considered the verified bill filed in this cause, and the application for a hearing for interlocutory injunction under Section 266 of the Judicial Code, and being advised that for the reasons set forth in said application and upon the grounds stated therein and in the verified bill, plaintiff is entitled to have its application heard under Section 266 of the Judicial Code:

It is ordered that the application be filed and a hearing of the application for an interlocutory injunction be had and proceeded with

in accordance with Section 206 of the Judicial Code as amended by Act of Congress Approved March 14, 1913, and such hearing is set down for April 15th, 1922, at the United States Court Rooms in the city of Raleigh, N. C.

It is further ordered, that notice of said hearing, not less than five days, shall be given to the Governor and Attorney General of the State of North Carolina, and to each of the defendants to this suit. And I hereby call to my assistance at said hearing of said application the Honorable Edmund Waddill, Jr., Circuit Judge of this Circuit, and the Honorable James E. Boyd, District Judge of the Western District of N. C.

This April 8, 1922, at Wilson, North Carolina.

H. G. CONNOR,
District Judge.

Extract from the Minutes of the Court.

April 15, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

Present: The Honorable Henry G. Conner, Judge of the District Court for the Eastern District of North Carolina.

Order.

"It is ordered that this cause be set down for final hearing on its merits on Monday, June 13, 1922, Counsel for Plaintiff and Defendants being in open Court and assenting thereto; application for Interlocutory Injunction being waived by Counsel for Plaintiff."

36 *Answer.*

Filed April 19, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

v.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et al.,
Defendants.

Answer.

To the Honorable H. G. Connor, Judge of the District Court of the United States for the Eastern District of North Carolina:

The defendants above named, answering the bill herein, respectfully show the Court that:

1. Article 1 of the bill is admitted.

2. It is admitted that the amount in controversy herein, exclusive of interest and cost, exceeds the sum of \$3,000. But defendants expressly deny that complainant has any equity to enjoin defendants from collecting the income tax attacked by said complainant; that said railroad company will be deprived of any privilege guaranteed and secured to it by the Constitution of the United States and the Fourteenth Amendment thereof; that it will be deprived of its property without due process of law; that it will be denied the equal protection of the law in contravention of the Constitution of the United States and the Fourteenth Amendment thereof, and that the taxes sought to be imposed by virtue and under the authority of the North Carolina statute constitute a direct burden upon interstate commerce, in violation of the commerce clause of the Federal Constitution.

3. It is admitted that the income-tax provision of the Constitution of North Carolina and the whole of Section 3 of Article V of the same are correctly set forth in Article III of the bill.

4. Article IV of the bill is admitted.

5. It is admitted that the portions of the Income Tax Act of 1921, as amended by the Special Session of 1921, quoted in Article V of the bill, are correctly quoted.

6. The first clause of Article VI of the bill is admitted. The complainant's allegation that said act is void as to it, is expressly denied.

(a) The income-tax provision of the Constitution of the State of North Carolina, quoted in Article IV of the bill, authorizes the Legislature to determine what shall be the net income to be taxed thereunder, and expressly prohibits the allowance of any deduction for living expenses. The statute enacted by the General Assembly of 1921, in pursuance of such constitutional authority, Chapters 34 and 35 of the Public Laws of 1921, classifies income-tax payers as follows, providing for each class a different method for ascertaining taxable incomes: first, resident individuals; second, nonresident individuals, Section 200; third, resident corporations; fourth, nonresident corporations, Section 201; fifth, railroads and other public-service corporations having their lines wholly within the State; and sixth, railroads and other public-service corporations having their lines partly within the State and partly without; and the defendants are advised, and so aver, that such classification does not in any way offend against any provision of the State or Federal Constitution. No one of these classes is allowed the same deduction or exemption as those allowed to the other classes, and in each case the distinctions made are made on account of an inherent difference between

the classes themselves. The statute itself (Section 202) provides the method by which the net income of railroads is to be ascertained. It declares that, as to such railroads operating wholly in the State, the net income shall be "the net operating income" as shown by their records, kept in accordance with the standard classification of accounts of the Interstate Commerce Commission. As to railroads, when their business is part within and part without the State, it declares their net income within the State shall be ascertained by taking their gross "operating revenues" within this State, including in their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business, and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the sum so found they are allowed to deduct "uncollectible revenue" and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and an equal mileage proportion of car hire, and the balance shall be deemed to be their net income taxable under this act. The method thus provided by the General Assembly for ascertaining the net income of such railroads, as defendants are advised and aver, is both legally and constitutionally a proper one to apply to them, and does not offend against the interstate commerce clause of the Federal Constitution.

(b) That deductions and exemptions are allowed individuals which are not allowed ordinary corporations or railroads, and that deductions are allowed ordinary corporations which are not allowed railroads, in specific terms, arises from the necessity to classify income-tax payers so as to arrive at their net income, and that necessity

arises from differences inherent in the various businesses thus classified. Without such classification, defendants are advised and believe, it would be impossible to levy a fair and just income tax.

Defendants are advised and believe that, in applying the method provided in the act, many deductions are necessarily allowed, besides those specifically set out in Section 202, "un-collectible revenue," and taxes paid in this State for the income year, etc., i. e., wages of employees, salaries of officers, if reasonable in amount, for services actually rendered in producing such income, and others too numerous to incorporate in this answer. A list of them is hereto attached, marked "Exhibit A," and is asked to be taken as part of this answer. It is admitted that interest paid during the tax year on outstanding bonded indebtedness is not one of the deductions allowed to railroads, whereas it is allowed to individuals and business corporations, but many other deductions are allowed to railroads which are not allowed to either individuals or business corporations. See "Exhibit A." Defendants are informed and believe, and so aver, that the method of financing railroads is so wholly different from that of other corporations that they are necessarily in a class to themselves with other public-service corporations, and that a refusal, under such circumstances, to permit a deduction for interest on their bonded indebtedness is justified and is not a discrimination against them. The statute (Section 306, subsection 3) expressly prohibits the deduction of dividends on preferred stock to business corporations.

(c) Section 202 was enacted, as defendants are advised and believe, so as to apply only to the companies described therein when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission. Any public-service company not coming within this designation would pay income tax under other provisions of the act. The process of arriving at the net income earned by railroads having part of their line in the State and part out is necessarily long and intricate. The General Assembly, knowing this, and knowing also that the simplest way of arriving at such a net income was by using as a basis the records required to be kept by the Interstate Commerce Commission, adopted that plan, and declared in Section 202 what should be the net income of such corporations in its application to them. Defendants deny that this classification is either unreasonable or arbitrary, and aver that instead it is based upon an evident distinction in the classes, and is valid and constitutional.

(d) It is admitted that the revenue laws of the State of North Carolina permit counties and other subordinate governmental agencies to levy an ad valorem tax on all property within their territorial limits, whether belonging to individuals, firms, or corporations, or railroads, subject to certain legal and constitutional restrictions. It is admitted that the State levies no ad valorem tax at all upon any of those classes. It does levy an occupation tax upon very many occupations, whether carried on by an individual or corporation, and it does levy a franchise tax upon all corporations, including railroads, and it does levy

an income tax upon all net incomes earned in the State, whether earned by an individual, a corporation, or a railroad. All these taxes, the defendants aver, are levied and collected according to equal and uniform rule, with only allowable and constitutional classification. It is expressly denied that this scheme of taxation, either in general outline or in the detail of its administration, is in any sense a burden upon interstate commerce.

(e) It is denied that the statutes imposing an income tax upon complainant are a violation of the scheme of taxation created and made mandatory by the Constitution of North Carolina. The amendments to the State Constitution, commonly called the taxation amendments, were adopted at the general election of 1920 and became effective January 7, 1921. The defendants are advised and believe that such amendments authorized the General Assembly of the State to adopt the general scheme of taxation which it commenced to put into effect at the Extra Session of August, 1920, and put in full force in the Revenue Act of 1921; that a general scheme of taxation is wholly within the authority of the State, and can only be attacked

41 when the legislation enacted in pursuance thereof, or the administration of such taxing laws, destroys some constitutional right of the complainant; that the refusal of the State to levy an ad valorem tax upon the property of the defendant, while it permits subordinate governmental agencies to levy this tax under the rules, regulations and restrictions contained in the State Constitution, can in no sense, as defendants aver and believe, impair any constitutional right of the complainant; that the State, as defendants are advised and believe, may constitutionally levy a license or franchise tax upon complainant for the privilege of performing its functions in the State; an income tax upon income earned in the State, and also an ad valorem tax upon its property for the benefit of the State; that its refusal to levy the latter tax cannot, as defendants aver, affect the constitutionality of the levy of the franchise and income tax. Defendants particularly deny that there has been any exemption of any class of property from the general burdens of taxation, as alleged in subsection (c) of Article VI of the bill; and defendants aver that the scheme of taxation of the shares in incorporated companies in the hands of the shareholders, as provided in the Revenue and Machinery Acts of 1921, has been in effect in the State for more than twenty years; said shares being taxed at the principal office of the corporation itself.

7. It is true that the Commissioner of Revenue has sent to complainant the form for return of income tax for the calendar year ending December 31, 1921, attached to the bill. It is admitted that he will proceed to collect, in accordance with the machinery of the law, a proper income tax from complainant. It is true that the Commissioner of Revenue may, under Section 504, issue an order, under his hand and official seal, directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer. The payment of such tax, however, will prevent any sale, and the taxpayer is given an adequate remedy at

law, in Section 7979 of the C. S. of 1919, and in an act of the
42 Extra Session of 1921, entitled "An act to refund taxes il-
legally collected and paid into the State treasury."

Defendants expressly deny that the penalties set forth in Section
600 of the Income Tax Act are excessive, unreasonable, oppressive,
and inequitable. Those penalties are imposed for wilful or fraudu-
lent failure to comply with the provisions of the act, and so would
not be a denial of due process of law to the complainant. The Re-
venue Commissioner and the Attorney-General are given authority to
waive or reduce the penalties therein provided for.

Wherefore, having fully answered all the allegations of the bill
herein, the defendants pray judgment:

1. That the bill be dismissed.
2. For cost of this action.
3. For such other and further relief as to the Court may seem just.

JAMES S. MANNING,
Attorney-General of North Carolina,
FRANK NASH,

Assistant Attorney-General of North Carolina,
Solicitors for Defendants.

GEO. H. BROWN,
WM. P. BYNUM,
LOCKE CRAIG,
THOS. D. WARREN,
S. S. ALDERMAN,
Of Counsel.

43 A. D. Watts, one of the defendants, being duly sworn, says
that he is State Commissioner of Revenue; that he has read
the foregoing answer and knows the contents thereof; that the same
is true, of his own knowledge, except as to matters therein stated on
information and belief, and as to those matters he believes it to be
true.

A. D. WATTS.

Sworn and subscribed to before me, this April 19, 1922.

EDWARD SEAWELL,
Deputy Clerk Supreme Court.

44 EXHIBIT A.

1. Maintenance of Way and Structures:

Superintendence; roadway maintenance—yard; roadway mainte-
nance—other; tunnels and subways—other; bridges, trestles and cul-
verts—yard; bridges, trestles and culverts—other; ties—yard; ties—
other; rails—yard; rails—other; other track material—yard; other
track material—other; ballast—yard; ballast—other; track laying

and surfacing—yard; track laying and surfacing—other; right of way fences—yard; right of way—other; crossings and signs—yard; crossings and signs—other; station and office buildings; roadway buildings; water stations; fuel stations; shops and engine houses; wharves and docks; telegraph and telephone lines; signals and interlockers; power plant buildings; miscellaneous structures; paving; roadway machines; small tools and supplies; removing snow, ice and sand; assessments for public improvements; injuries to persons; insurance; stationery and printing; other expenses; maintaining joint tracks, yards, and other facilities—Dr.; maintaining joint tracks, yards, and other facilities—Cr.

2. Maintenance of Equipment:

Superintendence; shop machinery; power plant machinery; steam locomotives—repairs; steam locomotives—depreciation; steam locomotives—retirements; freight-train cars—repairs; freight-train cars—depreciation; freight-train cars—retirements; passenger-train cars—repairs; passenger-train cars—depreciation; passenger-train cars—retirements; floating equipment—repairs; floating equipment—depreciation; work equipment—repairs; work equipment—depreciation; work equipment—retirements; injuries to persons; insurance; stationery and printing; maintaining joint equipment at terminals—Dr.; maintaining joint equipment at terminals—Cr.; other expenses.

45 3. Traffic:

Superintendents; outside agencies; advertising; traffic associations; industrial and immigration bureaus; insurance; stationery and printing.

4. Transportation—Rail Line:

Superintendence; dispatching trains; station employees; weighing, inspection, and demurrage bureaus; station supplies and expenses; yardmasters and yard clerks; yard conductors and brakemen; yard switch and signal tenders; yard enginemen; fuel for yard locomotives; water for yard locomotives; lubricants for yard locomotives; other supplies for yard locomotives; engine-house expenses—yard; yard supplies and expenses; train enginemen; train motormen; fuel for train locomotives; water for train locomotives; lubricants for train locomotives; other supplies for train locomotives; engine-house expenses—train; trainmen; train supplies and expenses; signal and interlocker operation; crossing protection; drawbridge operation; telegraph and telephone operation; operating floating equipment; stationery and printing; other expenses; insurance; clearing wrecks; damage to property; damage to livestock on right of way; loss and damage—freight; loss and damage—baggage; injuries to persons; operating joint yards and terminals—Dr.; operating joint yards and terminals—Cr.; operating joint tracks and facilities—Dr.; operating joint track and facilities—Cr.

5. Transportation—Water Line.

6. Miscellaneous Operations:

Dining and buffet service; hotels and restaurants; producing power sold; other miscellaneous operations.

7. General:

Salaries and expenses of general officers; salaries and expenses of clerks and attendants; general office supplies and expenses; law expenses; insurance; pensions; stationery and printing; valuation expenses; other expenses; general joint facilities—Dr.; general joint facilities—Cr.

46

Affidavit of A. R. Turnbull.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY.

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

A. R. Turnbull, being first duly sworn, deposes and says:

1. That he is President of the Rowland Lumber Company.
2. Rowland Lumber Company is a corporation duly organized and existing under the laws of the State of North Carolina, the principal business of the said company is the manufacture of lumber.
3. That it operates a large mill in North Carolina, located at Newbern, and has under lease a line of railroad extending from Clarks Junction, a point on the Atlantic & North Carolina Railroad, westwardly to and beyond New River and thence to Chinquapin, and a few miles beyond, where it connects with a line of railroad owned by Rowland Lumber Company, which extends to Kenansville, where it connects with a line of railroad owned by Atlantic & Carolina Railroad Company.
4. The principal business of the said railroad running from Kenansville to Clarks Junction, through Chinquapin is the transportation of logs and lumber for the owner of such railroad.
5. The Corporation Commission of North Carolina, acting under the power vested in it by section 3413 Consolidated Statutes of North Carolina, has granted to Rowland Lumber Company authority to transport commodities of certain kinds and character other than

owned by the said Rowland Lumber Company over that part of the said line of railroad between Kenansville and Chincupapin and to charge therefor a scale of rates fixed and established by the Corporation Commission of North Carolina.

47 6. Rowland Lumber Company does transport for others than itself commodities of the kind and character authorized by said authority to be transported and charges therefor the scale of rates authorized by the Corporation Commission.

7. That the Rowland Lumber Company is not engaged in interstate commerce and has never filed any tariffs with the Interstate Commerce Commission, and has not been authorized to engage in interstate commerce, and is prohibited under the law from so doing until it has filed tariffs with the Interstate Commerce Commission as required by the Interstate Commerce Act.

8. That during the calendar year 1921, which is the income tax year for 1921 in the state of North Carolina, Rowland Lumber Company paid rent for the line of railroad operated by it as aforesaid and also paid other rents for properties used in its said business and to which it had no equity except its leasehold, and also paid sums as interest for money borrowed and used in its business.

9. Affiant is informed and believes that Rowland Lumber Company is, under the income tax law of North Carolina, schedule D, of Chapter 34, entitled to deduct the amounts so paid as interest and rent, together with other deductions allowed by said schedule from its gross income, in order to arrive at its net income subject to tax under the said tax laws of North Carolina.

10. That the said railroad is of standard gauge and can and does receive cars from other lines of railroad, which it transports to destination on its own line.

A. R. TURNBULL.

Sworn and subscribed to before me this 20th day of May, 1922

[SEAL.]

J. B. DEY, JR.,
Notary Public.

Com. expires Sept. 18, 1923.

48

Affidavit of Nathan O'Berry.

Filed May 23, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue *or* North Carolina, et al.,
Defendants.

Nathan O'Berry, being first duly sworn, deposes and says:

1. That he is a citizen and resident of the State of North Carolina and County of Wayne, that he is President of Enterprise-Whiteville Lumber Company.

2. That said company is an industrial corporation engaged in operating lumber mills located respectively at Whiteville and Mt. Olive, North Carolina.

3. That said company, as a part of its business constructed a line of railroad extending from Whiteville, N. C., to Butlers, N. C., a distance of about 27 miles, and also constructed a line of railroad extending from Mt. Olive, N. C., to New Camp, N. C., a distance of about 18 miles.

4. That said railroads were established and maintained solely by the owner of the lands upon which the said roads were constructed and the principal business of said railroad is the transportation of logs, lumber and other articles of the owners of said railroad.

5. Acting under the provisions of section 3413 of the Consolidated Statutes of North Carolina, the said corporation applied to the Corporation Commission of North Carolina for authority to said corporation to transport between the termini of said two lines of railroad, commodities other than that owned by the said lumber company, and for authority to charge therefor reasonable rates to be approved by said corporation.

6. The Corporation Commission, under the powers vested in it under said section 3413 of the Consolidated Statutes of North Carolina, duly authorized the said corporation to act as a common carrier between the termini of its said two lines of railroad and established a scale of rates which said corporation might charge for the

transportation of the kind and character of commodities which it was authorized to transport for others for such services.

7. That the said Corporation does not have any Tariff filed with Interstate Commerce Commission, and is not authorized to and does not engage in the transportation of freight or passengers in interstate commerce, or between any points other than those on its own line. That the said corporation, during the year 1921, paid interest on account of money borrowed, that the said corporation in making its income tax returns to the Commissioner of Revenue of the State of North Carolina, deducted from its gross income the interest so paid in order to arrive at its net income, this deduction being made in addition to the other deductions allowed under section 306, schedule D of the Revenue Act of North Carolina.

8. This affiant is informed and believes that it was entirely proper under the laws of North Carolina for said corporation to deduct the interest paid during the year 1921 from its gross income, together with the other deductions allowed in section 306 of schedule D, Revenue Act of North Carolina from its gross income in order to ascertain the net income subject to tax.

NATHAN O'BERRY.

Sworn and subscribed to before me this 17th day of May, 1922.

[SEAL.]

C. W. BRINKLEY,
Notary Public.

My Commission expires January 24th, 1924.

50

Affidavit of C. D. Bradham.

Filed May 25, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

C. D. Bradham, being first duly sworn, deposes and says that he is President of the Atlantic & North Carolina Railroad Company; that prior to the year 1921, the Atlantic & North Carolina Railroad Company leased to the Howland Improvement Company its line of railroad, extending from Morehead City to Goldsboro, North Carolina.

That the Norfolk Southern Railroad Company is the successor in title to the said leasehold interest granted by said lease and during the year 1921 was in possession of said line of railroad under said

lease and used the same exclusively and conducted and carried on the business of a common carrier over said line of railroad.

That during the said year 1921, Norfolk Southern Railroad Company paid the Atlantic & North Carolina Railroad Company the amount of rent required by said lease to be paid for the continued use of said property in the trade or business of Norfolk Southern Railroad Company; that the payment of the said rent was a condition precedent to the continued use of the said property by the Norfolk Southern Railroad Company in its business.

That the Norfolk Southern Railroad Company has not taken title to the said property, was not taking title thereto, and has no equity in the property owned by the Atlantic & North Carolina Railroad company.

51 That under the terms of the said lease, Norfolk Southern Railroad Company, as Lessee, is required to pay any Income Tax levied upon the income of the Atlantic & North Carolina Railroad Company derived from or under said lease.

That the amount of money received from Norfolk Southern Railroad Company as rent for the use of said property is substantially the entire income of the Atlantic & North Carolina Railroad Company.

C. D. BRADHAM.

Subscribed and sworn to before me this 17th day of May 1922.

[SEAL.]

H. J. CARPENTER,

Notary Public.

My commission expires on the 7th day of Oct. 1922.

52 *Affidavit of O. S. Thompson.*

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als., Defendants.

Railroad Income Tax Suits.

Affidavit of O. S. Thompson.

O. S. Thompson being duly sworn, deposes and says:

Since 1906 affiant has been connected with the Corporation Commission of North Carolina, and with the State Department of

Revenue since its creation in 1921. The Corporation Commission, in addition to its duties as such, was by statute created the State Tax Commission with the duties of administering the tax laws of the State. Affiant's position with the said State Tax Commission was that of Tax Clerk, and as such his duties were the general supervision of the details of the administration of the tax laws of the State. While Tax Clerk of the State Tax Commission affiant had extensive experience with the Standard Classification of Accounts of the Interstate Commerce Commission in connection with preparing the reports of the Corporation Commission based in part on the said Standard Classification.

Affiant is now Deputy Commissioner of Revenue of North Carolina and acting Chief Clerk of the State Department of Revenue and his duties as such are similar to those formerly performed by him as Tax Clerk of said State Tax Commission. Prior to 1906 affiant served as an employee of the Southern Railway Company as clerk handling taxation matters.

In his capacity as Deputy Commissioner of Revenue and acting Chief Clerk of the State Department of Revenue the affiant is familiar with the requirements of that Department as to returns for taxation by taxpayers, with the forms of such returns, and is custodian of the records of the State Department of Revenue. Affiant is familiar with the administration of the tax laws of the State by the State Department.

The State Department of Revenue has only one blank for returns for income tax which is sent out to and used by all railroad corporations engaged in the operation of railroads. This is known as Form 7, and is attached to this affidavit, marked Exhibit A. This form is required by the State Department of Revenue to be filled out by all railroads doing business in the State of North Carolina, whether operating partly within or partly without the State, whether operating wholly within the State but as common carriers with interstate railroads, or whether doing wholly intrastate business. This Form 7 requires a report by all such railroad corporations of their net income as defined by the Income Tax Act of 1921, under the provisions of section 202 of that Act, and based upon and according to the Standard Classification of Accounts of the Interstate Commerce Commission.

53 The State Department of Revenue requires all such railroad corporations to make return for income taxation upon this form and ascertain the net income of such railroads for taxation without discrimination according to the provisions of the said section 202.

Affiant has read the affidavits of Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, and of Mr. A. B. Turnbull, President of the Rowland Lumber Company, filed in their suits by the Norfolk and Southern Railway Company. It is true that these lumber companies and other similar companies are not classed as railroads by the State Department of Revenue, are not treated as railroads for income tax purposes or for any other purpose whatsoever, and are not required to make returns for income tax

according to the Standard Classification of Accounts and upon Form 7, but are required to and do make return for income tax on Form 3, which is the Form required by the Department for corporations in general other than the railroads and other public service corporations taxed according to section 202. In fact, these lumber companies and other similar companies are not railroads and are not public-service corporations. As is stated in the said affidavit by the presidents, their principal business is the lumber business, only such transportation as they carry on is principally the transportation of their own property as incident to the lumber business. Under section 3413, Consolidated Statutes, the Corporation Commission has the power to grant to such companies authority to transport certain commodities other than their own property, subject to the supervision of the Commission, but the affiant is informed and believes that the purpose of such provision is simply to allow such companies to accommodate immediate communities in which they operate; that when such authority is granted to and exercised by such companies they do not engage in the business of transportation as common carriers for others for profit, but only as the purely incidental service of accommodation; that in any such case the transportation of property of others by such a corporation is wholly negligible in amount and purely incidental to the principal business of the corporation, which is the lumber business.

Affiant states, therefore, as a matter of his own knowledge, that the Income Tax Act of 1921, as administered by the State Department of Revenue, applies exactly in the same way and without any discrimination whatsoever to all railroad corporations doing any business in the State engaged in railroad operation, whether foreign or domestic, whether operating partly within and partly without the State, or wholly within the State. All are required to make return for income tax according to the Standard Classification of Accounts and under section 202, and exactly the same deductions are allowed to all, without discrimination.

Not only is the entire class of railroads subjected to income taxation under the provisions of section 202 with ascertainment of net income upon the basis of the Standard Classification of Accounts, but the same is true as to the broader class of all strictly public service corporations, not including such lumber companies as are above referred to and which the affiant is informed and believes are not public-service corporations at all.

The State Department of Revenue has one form for income tax return for all public service corporations other than railroads, Form 8, a copy of which is attached hereto and marked Exhibit B, and which form is substantially identical with Form 7 upon which railroads are required to make return. The Department of Revenue requires, therefore, not only of railroads, but of all other public service corporations, that they file returns for income tax upon the basis of the Standard Classification of Accounts, under the provisions of section 202.

Affiant has read the affidavit of Mr. J. H. Bridges, President of the Henderson Water Company, in which Mr. Bridges

states that the Henderson Water Company is not required to and does not keep its records according to the Standard Classification of Accounting, and that it did not make return for income taxation according to the said classification under the provisions of section 202. Affiant states that the returns for income taxation in the office of the Department of Revenue for the year ending December 31, 1921, have not yet been audited and checked for correctness. If what Mr. Bridges says with reference to the return made by the Company is true, his company will be required to amend its return and to file a return on Form 8 according to the said Standard Classification and under the provisions of section 202. As the Department of Revenue interprets the Income Tax Act, the Henderson Water Company, as well as all other public service corporations, are required by it to make return for income tax in accordance with the accounting system of the Standard Classification. The auditing of income tax returns for the said year is in progress at this time, but has not been completed, and, with reference to railroads and other public-service corporations, has been held over pending decision in these suits as to the validity of the income tax as to such corporations, in view of the plaintiff's attack upon the income tax law as applied to them.

O. S. THOMPSON,

Affiant.

Subscribed and sworn before me this the 5th day of June, 1922.

[SEAL.]

W. H. PITTMAN,

Notary Public.

My commission expires July 29, 1922.

55

Affidavit of A. J. Maxwell.

Filed June 5th, 1922.

In Equity.

#449.

In the District Court of the United States for the Eastern District of North Carolina.

SOUTHERN RAILWAY Co. et als., Plaintiffs,

v.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.
Defendants.

Railroad Income Tax Suits.

Affidavit of A. J. Maxwell.

A. J. Maxwell, being first duly sworn, deposes and says:

Affiant is a member of the State Corporation Commission of North Carolina and has been such since 1910, during which time the said

commission was, until 1921, also the State Tax Commission with the duties and functions with reference to administering the tax laws of the State imposed upon the newly created State Department of Revenue by the statute of 1921. In such position the affiant has been directly connected in an official capacity with the administration of the tax laws of the State until the creation of the State Department of Revenue to replace the State Tax Commission as such. In such capacity the affiant was in constant consultation with the finance committees of the General Assembly at the time of the drafting of the Income Tax Act of 1921. In such capacity the affiant has had extensive experience familiarizing him with the Standard Classification of Accounts of the Interstate Commerce Commission, has made a special and comparative study of the taxation systems of other states and of the subject of taxation.

When the enactment of the Income Tax Act of 1921 was under consideration in the finance committees of the General Assembly, the railroads were heard on the matter and they made the same objection to the provisions of Section 202 that they are now making in these suits. They argued that the application of those provisions to them would not lead to an ascertainment of their net income because certain items, notably interest on bonded indebtedness and rentals paid for leased properties, were not included in the operating expenses in the said Standard Classification, whereas as to individuals and to corporations other than public service corporations deductions were allowed under general terms of the Act which the railroads alleged to be analogous to such interest and rentals.

The legislative committees considered these objections fully and carefully. In enacting the Act in the terms, finally adopted, the General Assembly considered certain well known facts with reference to the method in which railroad corporations are financed. It is a general rule that railroads are financed almost entirely by bond issues, their stock being issued largely incidentally and sometimes even distributed as bonus with the bonds. The rule is that the capital finances are procured by bond issues. This being the case, interest paid on the bonds is properly considered not as a current, operating, or business expense, but as a capital expense. The legislature considered that "net income" as generally understood and as judicially defined means the business revenues less all those expenses incurred in the earning of such revenues, but not deducting any expense on account of or to provide for capital or permanent investment in the business. It was manifest, therefore, that if interest on bonds should be allowed as a deduction in arriving at net income of railroads, this would be the allowing of a capital expense not an operating or business expense, and the result obtained after making such deduction in addition to operating and business expenses would not be the net income of the railroad but less.

With reference to the matters of rentals paid for the lines leased and operated by the railroads, the committees considered the well-known facts that these leases are usually for long terms and with numerous collateral obligations which make them amount practically

to purchases of the lessor road's properties by the lessee, and that, this being true, the consideration paid for such long leases of property used fully as if the property of the lessee in its business is really not an operating expense but is by clear analogy and in practical effect a capital expense. If these expenses were allowed as deductions to the plaintiffs, the result would be that they would have no income subject to tax until they had earned enough to provide, not only for all business and operating expenses, but also for all capital expenses and had paid all interest on their bonds; in other words, it would amount to nothing more than a tax on the savings of railroads, which would render the tax utterly incommensurate with that imposed as income tax on individuals and other ordinary corporations.

Affiant states it as his opinion that the Income Tax Act as applied to railroads and other public service corporations under the provisions of Sec. 202 results in a strictly fair and just tax upon their net income, entirely commensurate in scope and burden with the tax imposed on other corporations, and individuals, except that perhaps, in view of the fact that individuals are allowed no deduction whatever for living and family expenses, which expenses are analogous to many items allowed all corporations as deductions, the tax bears relatively more heavily on individuals than on corporations by reason of the constitutional inhibition against allowing such deductions to individuals.

As to the contention of the plaintiffs that it is arbitrary classification and discrimination to base a classification on the question whether the taxpayer is required to keep his accounts in accordance with the Standard Classification, the affiant is advised and believes, and so states, that so long as all railroads are placed within the class and are treated alike without discrimination, the classification is reasonable and not arbitrary, because the distinction of being railroads and not other corporations is a practical and reasonable basis of distinction and classification. Affiant asserts further that all railroads are taxed alike under the Income Tax Act of 1921. All are required to make return for taxation on Income Tax Blank Form 7, according to the Standard Classification of Accounts; and that the class is even broader than that of railroads, including all other public service corporations, these being required to make return on Form 8, according to the same Standard Classification, as sworn to in the affidavit of O. S. Thompson filed by the defendants herein.

When railroads keep the Standard Classification of Accounts, under Federal or State requirement, the only practical method of requiring return for income tax to be made is according to such classification of accounts, and for the State to require different accounting, or to require return according to another system of accounting, would conflict practically with the power of the Interstate Commerce Commission to prescribe uniform classification of accounts.

57 The State of North Carolina has not undertaken to prescribe any system of accounting for the plaintiffs or other railroads in conflict with that already required to be kept by the Interstate Commerce Commission, but has adopted that system

the best and most practical basis for the calculation of net incomes for taxation.

A. J. MAXWELL,
Affiant.

Subscribed and sworn to before me this 5th day of June, 1922.
[SEAL.]

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

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Affidavit of R. O. Self.

Filed June 5, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY et als., Plaintiffs,

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, et als.,
Defendants.

Railroad Income Tax Suits.

Affidavit of R. O. Self.

R. O. Self being duly sworn, deposes and says:

Affiant is the clerk of the State Corporation Commission of North Carolina, has been such since the first of September 1919, and as such is the custodian of the records of the said Commission and is thoroughly familiar with the administering by the Commission of its duties and powers given it by statute. He is thoroughly familiar with the classification made by the Corporation Commission of corporations subject to its supervision.

Affiant has read the affidavit of Mr. A. R. Turnbull, President of the Rowland Lumber Company, which affidavit is filed by the Norfolk Southern Railroad Company in these suits, and affiant is familiar with contents thereof. He has also read and is familiar with the contents of the affidavit of Mr. Nathan O'Berry, President of the Enterprise-Whiteville Lumber Company, filed by the said plaintiff in these suits.

The said Rowland Lumber Company, and the said Enterprise-Whiteville Lumber Company do what is known as a limited transportation business, and are authorized by the Commission to carry in their logging roads certain limited commodities other than their

own property. These corporations are not railroad Corporations, but are lumbering corporations. Their lines of tramway, or railroad, are constructed by them for the purpose of hauling logs and lumber and operating their lumber business. When such roads are established

59 there are frequent demands by the communities through which they run, for them to transport other commodities for the convenience and accommodation of the inhabitants of those communities. Under Section 3413, Consolidated Statutes, the Corporation Commission has the power to, and in proper cases does, grant authority to such logging or lumber companies to carry for hire over their logging, or tramway, roads commodities of others within certain limitations.

These corporations are not classed, considered, or treated by the Corporation Commission as railroads, but they are subjected to the supervision of the Commission, chiefly to prevent discrimination as to the very limited carrier service which they are allowed to perform. They are not classed as common carriers, in the same class as railroads such as the plaintiffs in these suits.

As to the Rowland Lumber Company, it entered into the business referred to in the affidavit of Mr. Turnbull not for profit, but purely for the accommodation of the community, as the following quotations from letters and documents will show:

Letter from Mr. A. R. Turnbull, President, Rowland Lumber Company to W. G. Womble, Rate Clerk, State Corporation Commission, Raleigh, N. C., March 22, 1918:

"It is true that we have been handling fertilizer over the west end of our road for the benefit of the people located in that territory. This is merely an accommodation to them, and is of no benefit to us; * * * If these people do not care for this accommodation it will certainly be a great pleasure for us, under present circumstances to discontinue this hauling of freight for them, as it is done absolutely at cost to us on the present basis."

Letter from Stevens & Beasley, Attorneys for the Rowland Lumber Company, to the North Carolina Corporation Commission, dated March 27, 1918. This letter after referring to complaints made by certain citizens of Faison, N. C., against the Rowland Lumber Company for alleged excessive charges for hauling fertilizer says:

"The Rowland Lumber Company is not operating a logging business, over its road, this year, in Sampson County to any extent but is confining its operations to its log road in Duplin. It has not even determined to open up its road in Sampson County for the carrying of freight as charged, but was simply coming to the rescue of the farmers of Sampson County, and aiding them, as all good citizens should do, in making food for fighting Germany. For all the winter the roads in that section have been almost impassible with an empty vehicle and had the farmers, many of them 15 miles from the railroad, been permitted by the roads to have hauled at all the cost would have been enormous, from \$3 to \$

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per ton and in this emergency the Rowland Lumber Company has been helping them out at great inconvenience to itself and even a loss. Labor conditions are such the cost of operating is so high that no one except a man like Mr. Turnbull would have undertaken to deliver the fertilizer to these people and he regrets that they have been so shortsighted as to kick, for it might have been possible for the road to have been developed into a public carrier under his generous impulses and public spirit. In building the Atlantic & Carolina Railroad, he has done more for Duplin County than any other one man."

The authority granted to the Rowland Lumber Company, as aforesaid, was granted pursuant to petition filed by the Rowland Lumber Company with the Corporation Commission, copy of which is attached hereto and marked Exhibit "A," and which petition shows that it was made purely to accommodate citizens, who requested such service of the Rowland Lumber Company.

On the 27th of February, 1922, Mr. A. R. Turnbull, President of the Rowland Lumber Company, addressed another letter to Mr. W. G. Womble, Rate Clerk, Corporation Commission, in which he said:

"As you will understand we are not operating on piece of road west of Bowden, but are simply hauling fertilizer, etc., for the accommodation of people in that territory. We would be money ahead by discontinuing this service, and will do so if you deem it necessary, but in the meantime, we will do the best we can to give them all the service possible. We have left one locomotive at Bowden to attend to this business and hope to give them better service this year than we have in the past. On the two points, Newton Grove and Eureka Church, however, there will be some delay, and we have notified all shippers whom we know that we do not care to handle this business except in that way."

There is attached hereto and marked Exhibit "B," a schedule of the rates of the Enterprise-Whiteville Lumber Company over its logging road, effective December 1, 1920, as filed with the Corporation Commission, which schedule shows the limitation as to the commodities carried and allowed to be carried by this road.

These logging roads and others similar to them are not classed as railroads and as full common carriers by the Corporation Commission for the reasons above shown, for the reason that their business of carriage of property of others is purely incidental to their business of logging and manufacturing lumber, and is negligible in amount, and for the reason that they maintain no regular schedule of trains, but run simply when there is particular demand for a particular carriage.

R. O. SELF,
Affiant.

Subscribed and sworn to before me this 5th day of June, 1922.

[SEAL.]

W. H. PITTMAN,
Notary Public.

My commission expires July 29, 1922.

EXHIBIT "A."

Rowland Lumber Company.

Norfolk, Va., May 21, 1918.

To the Corporation Commission of North Carolina:

The Rowland Lumber Company respectfully sheweth to the Corporation Commission of North Carolina:

1. That it is a corporation incorporated under the laws of the State of North Carolina, authorized to engage in the Lumber business. In the operation of its timber it has purchased, and caused to be constructed, for logging purposes, a line of railroad running from Bowdens and Warsaw, on the Atlantic Coast Line Railroad, in Duplin County, North Carolina, in a westerly direction for about twenty miles toward Newton Grove.

2. Your petitioner has been, and is continually being, requested by the citizens living along the line of this road to transport freight for them and others; your petitioner is willing to accommodate such parties under present conditions, provided it can do so lawfully.

3. Under Revisal of 1905, Sec. 2598, as amended by Chapter 160 Laws of 1911, your Honorable Body is empowered to authorize this company to transport commodities, and to charge therefor reasonable rates, in addition to the transportation of its own commodities:

Wherefore, your petitioner respectfully prays, that your Honorable Body authorize your petitioner to transport over its logging road, as freight, commodities in carload lots, but excluding lumber and logs, purchased and used along the line of said road, and to make charges therefor; and that this authority be continued from year to year until your petitioner shall give to this Honorable Body necessary notice of its intention to discontinue said service.

Respectfully submitted,

(S.) ROWLAND LUMBER COMPANY,
By A. R. TURNBULL,
President and General Mgr.

EXHIBIT "B."

Rates of Enterprise Lumber Company Railroad.

Effective December 1, 1920.

Fruit and vegetables, per crate.....	20	20	25	25	25
Fruits and vegetables, per car.....	1500	1650	2000	2250	2500
Empty Crates or Barrels, " ".....	1500	1650	2000	2250	2500
Ditto each.....	10	10	12½	15	15
Fertilizers, 20 Tons Maximum.....	2500	2600	3250	3500	4000
Fertilizers from 10 to 20 tons, per ton minimum 1,500 per car.....	150	175	200	225	275
L. C. L., per ton.....	300	300	350	400	450
Cotton Seed and Hulls.....	2000	2200	2700	3000	3300
L. C. L., per ton.....	200	250	325	375	400
Holly, Lime and Flour in carload.....	2000	2200	2600	2800	3000
Wood—Minimum 10 cords, per c.....	100	100	110	125	150
Cotton, per bale.....	150	150	150	175	175
Furniture, per 100 pounds.....	25	27	30	30	35
Chickens and eggs, per crate.....	30	20	30	30	30
Mdsc. not classed, per 100.....	20	20	25	25	30
Brick, minimum 10 per m.....	300	300	300	300	350

All freight is to be loaded and unloaded at expense and risk of shipper. We will not accept any freight either carload or L. C. L. from or to any point except the following:

Oliver's Siding.....	3
Taylor's Siding.....	3½
Loftin's Siding.....	3½
King's Crossing.....	5½
Dobson's Crossing.....	7¼
Hill's or Cherry's Siding.....	9½
Scott's Store.....	12
Brown's Camp or Snow Hill.....	13
Woodland Siding C. L. only.....	16
Kornegay's Bridge " ".....	17

All cars have to — unloaded on the same day they are placed, or demurrage will be charged. No freight will be shipped collect. Package freight will be carried out only on Fridays and if placed at warehouse on any day previous to Thursday it will be held by this Company at the shipper's risk. Carload shipments will be taken out any day in the week.

ENTERPRISE LUMBER COMPANY.
THOMAS O'BERRY, *General Mgr.*

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Affidavit of J. H. Bridgers.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, and
Others, Defendants.

J. H. Bridgers, being duly sworn, says: That he is President of Henderson Water Company, a corporation incorporated under the laws of the State of North Carolina, and engaged in the business of supplying water to the public in the town of Henderson, N. C.; that the said corporation is engaged in public service. That the said corporation is not required to and does not keep its records according to the standard classification of accounting of the Interstate Commerce Commission. That after making the deductions allowed it under the Income Tax Act of North Carolina of 1921, the said company has no taxable income. That there is attached to this affidavit and made a part hereof a duplicate of the income tax return filed by the Henderson Water Company with the Commissioner of Revenue of North

Carolina, as required by the Income Tax Act of North Carolina of 1921, upon which said return it appears that the said company after making the deductions allowed corporations under the provisions of the said Income Tax Act, the Henderson Water Company has no taxable income. That there is also attached hereto and made a part of this affidavit a form for income tax return by corporations designated in Section 202 of the Income Tax Act, which has been filled out from the books of the Henderson Water Company and which correctly shows the amount of taxable income upon which the said company would be required to pay the income tax if it came within the corporations designated by said Section 202 and was required to keep its accounts according to the standard classification of accounting of the Interstate Commerce Commission, and from which it appears that said corporation would be required to pay an income tax of \$167.23, if its income taxable under the law were required to be determined on the basis of said return.

J. H. BRIDGERS.

Subscribed and sworn to before me this 14 day of March, 1922.

J. A. SCOTT,
Notary Public.

My commission expires 2 day of May, 1922.

EXHIBIT "A."

Form 8.

State Department of Revenue.

Public-service Corporation Income Tax Return Other Than Railroads.

For Calendar Year Ending December 31, 1921.

Name and kind of business Henderson Water Company.
Business address, Henderson.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

President.

Treasurer.

Sworn to and subscribed before me, this — day of —, 1922.

(Official capacity.)

Operating Revenues, in this State, including mileage proportion of interstate business as per standard Classification of Accounts of Interstate Commerce Commission	\$32,101.83
Operation Expenses, as per standard Classification of Accounts of Interstate Commerce Commission	26,079.00
Net operating revenue	\$6,022.00
All other income .....	.....
Total income	\$6,022.00
Less taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes	771.00
Net taxable income	\$5,241.00
Tax @ 3%	\$167.23

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Railroads and public-service corporations; basis of ascertaining Net Income.—The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the "net operating income" of such corporations as shown by their records kept in accordance with that standard classification of accounts when their business is wholly within this State, and when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their net income within this State shall be ascertained by taking their gross "operating revenues" within this State the equal mileage proportion within this State of their interstate business and deducting from their gross "operating revenues" the proportionate average of "operating expenses," or "operating ratio," for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts. From the net operating income thus ascertained shall be deducted "uncollectible revenue," and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act.

Car Hire Considered.—In determining the taxable income of a corporation engaged in the business of operating a railroad under the preceding section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire.

EXHIBIT "B."

Form 3.

State Department of Revenue.

Corporation Income Tax Return.

For Calendar Year Ended December 31, 1921.

(Make Affidavit on This Page for Either Blank.)

Name and kind of business, Henderson Water Company—Public Water Supply.
Business address, Henderson, N. C.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act for 1921 and the Regulations issued under authority thereof.

J. H. BRIDGERS,
President.
J. H. BRIDGERS,
Treasurer.

Sworn to and subscribed before me, this 10 day of Mar., 1922.

(Official capacity.)

Corporation Income Tax Return.—Continued.

What was the net income for the calendar year 1921 returned to the U. S. Government before taking off any exemption allowed by the Federal law or State income tax	\$	None.
Bad debts charged off in Federal return and not deductible in this return		None.

Total	\$
-------------	----	-------

Deduction.

Dividends not taxable by State, included in Federal return
--	--	-------

Net income under State law, all of which is taxable	\$
---	----	-------

Tax at 3 per cent	\$	None.
-------------------------	----	-------

If Above Form Is Used, It Is Not Necessary to Fill Out This Form.

Gross Income.

1. Gross sales less returns and allowances .....	\$	.....
Plus inventory close of year		\$
2. Less cost of raw materials .....	\$	.....
.....	
.....	
.....	
.....	
Wages and labor .....		.....

Total raw materials, wages and labor

*

Plus inventory beginning year.....	\$.....	
Gross income from operation.....		\$32,101.83
3. Gross income from operations other than trading or manufacturing.....		
4. Taxable interest received from all sources.....	\$.....	
5. Rentals.....	.....
6. Royalties.....	.....
7. Income received from partnership.....	.....
8. Total dividends received from foreign corporations, no part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
9. Total dividends received from foreign corporations, part of which corporation's income is subject to income tax under the State law. Attach statement showing names of corporations and amount received from each.....	.....
10. Gross income from all other sources subject to tax.....	.....
11. Total income, 3 to 10.....	
12. Total gross income, 1 to 11.....	\$.....

Corporation Income Tax Return.—Continued.

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Deductions.

1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business	\$.....
2. Reasonable compensation of officers.....	.....
3. Rentals or other payments required to be made as a condition of the continued use or possession, for the purpose of the trade or property to which the taxpayer has not taken, or is not taking title, or in which he has no equity.....	.....
4. All interest paid during the income year on indebtedness, except interest on obligations contracted for the purchase of nontaxable securities. Dividends on preferred stock shall not be deducted as interest.....	.....
5. Taxes for the income year, except taxes on income and war profits and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.....	.....
6. Dividends from stock in any corporation the income from which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this act only a corresponding part of the dividends received therefrom shall be deducted. Attach statement of such dividends.....	.....
7. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.....	.....
8. Debts ascertained to be worthless and charged off within the taxable year if the amount has previously been included in gross income in a return under this act.....	.....

[illegible]

Plant	199,572.42	213,806.19
Addition 1921	.....	.....
.....
.....
.....
.....

Deferred Assets:

.....
.....
.....
.....
.....
Total assets	\$.....	\$.....

Liabilities.

Notes payable	.....	.....
Accounts payable—Receiver's Certificates	.....	.....
Accrued items	\$8,500.00	\$9,000.00
.....	.....	10,000.00
Other liabilities—Bonded Debt	.....	.....
Reserve for bad accounts	97,500.00	97,500.00
Reserve for depreciation	35,672.62	37,014.48
Other Reserves:	.....	.....
Capital stock—Common	.....	.....
Preferred	65,400.00	65,400.00
Surplus	.....	.....
Undivided profits	.....	.....
Total liabilities	\$.....	\$.....

Affidavit of J. B. Duke.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

DISTRICT OF COLUMBIA,
City of Washington:

Personally appeared before me, a Notary Public, in and for the District of Columbia and City of Washington, J. B. Duke, a resident of the City of Washington, District of Columbia, who, upon being duly sworn, deposes, and says:

That he has been connected with the Accounting Department of the Southern Railway Company since March 1900, and is at this time the General Auditor of the Company, in charge of its books and accounts, which are under his immediate supervision and jurisdiction.

Affiant says that for the year 1921 the Southern Railway Company paid:

Item I. C. C.

Classification.

538.—Rent for passenger train cars..... \$491,206.10

Southern Ry. received:

505.—Rent from passenger train cars..... 332,038.58

In other words, the Southern paid out for rent of passenger train cars in 1921..... 159,167.52

73 more than it received, of which amount 17½% or \$27,854.35 should be charged against its income in North Carolina.

Affiant further says that the Classification of Accounts of the Interstate Commerce Commission has as item 536 "hire of freight cars" which is commonly known as car hire, and that the Interstate Commerce Commission Classification has as item 538 "rent for pas-

senger Train cars" which is separate from and not that account which is commonly known as car hire.

Affiant further says that under item 541 of the Interstate Commerce Commission Classification known as "joint facility rents" there is a debit against the Southern Railway Company applicable to North Carolina of \$213,767.07, the principal items of which debit are the cost of trackage right Selma, N. C., to Pinners Point, Va., and the cost for the use of terminals at Durham, Goldsboro and Raleigh, N. C.

J. B. DUKE,

Subscribed and sworn to before me, this 8th day of June, 1922.

[Notarial Seal.]

J. C. NAUGHTEN,
Notary Public.

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Affidavit of M. S. Hawkins.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

M. S. Hawkins, being first duly sworn, deposes and says that he is Secretary of Norfolk Southern Railroad Company, having occupied that position since the Company's organization in 1910.

If it is intended by the affidavit of A. J. Maxwell filed in this cause to suggest that the capital stock of this Company was issued as a bonus or gift, such statement is incorrect and untrue.

Norfolk & Southern Railway Company, predecessor in title of complainant, in many of its properties, issued and sold mortgage bonds to the amount of fourteen million dollars and also certain capital stock, as appears from the records of that company.

Norfolk & Southern Railway Company, being unable to meet its obligations as they matured, the Mortgage securing the bonds was foreclosed and the property was sold and bought by a committee of bondholders who issued the capital stock of the present Norfolk Southern Railroad Company to the bondholders of the Old Norfolk & Southern Railway Company in lieu of the said bonds and stocks.

Under no system of accounting that affiant has ever seen or heard of, can interest paid by an operating corporation be properly charged as a capital expense. Capital expenses are supposed under all proper systems of accounting to represent expenditures made to increase the

- assets of the Company, while interest is a liability incurred
 75 for the use of money borrowed and chargeable to income, and constitutes a liability and not an asset.

A system of accounting which provided for entering interest paid by an operating corporation as a capital expenditure would be incorrect, misleading and calculated to lead to gross errors, if nothing more.

One of the chief differences between interest and dividend is that interest is a direct obligation of the borrower to pay the lender for the use of money, whether a profit is made or not, while dividends are not a direct obligation to pay at all hazards, as is interest, but dividends can properly be payable only out of net earnings of the business after all expenses, (including interest) and losses, are paid, adjusted, liquidated or taken care of, leaving the capital intact.

Under the Income Tax Laws of North Carolina, as affiant understands them, as to individuals and all corporations other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee, or recipient of the interest, (lender of the borrowed money on which interest accrues) is required to include interest received (except that on certain governmental obligations) in his or its gross income for the purpose of ascertaining the net income subject to tax, and the payer of such interest (borrower of the money) deducts the interest thus paid from his or its gross income, while in the case of dividends the payee, or recipient of the dividends, excludes or omits the dividends from his or its gross income, and the payer of such dividends includes the amount paid as a part of his or its taxable income (provided that the payer pays an income tax to the State) thus the amount so paid as either interest or dividends is only taxed as income one time.

In case of corporations required to keep records according to the standard classification of accounting of the Interstate Commerce Commission (if the statute is held constitutional) both
 76 the payee of the interest (that is the lender of the money) and the payer of the interest (the borrower of the money) will be compelled to include the interest received and paid in their gross income, for taxation without allowing any deduction to either, thus making double taxation.

So with rent paid for use of property by individuals and corporations, other than those required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, the payee or lessor of certain property includes rent received in his or its gross income, and the payer of the rent, or lessee of the property, deducts the amount of rent paid from his or its gross income, and the money representing such rent is taxed once only for income purposes, while under the statute, (if constitutional) corporations keeping their records according to the standard classification of accounting of the Interstate Commerce Commission, renting property for use in the business, the payee or lessor of the property, must include the rent received for the use of such property in his or its gross income for the purpose of income taxation, and the

payer of such rent, or lessee, it not permitted to deduct such rent from its gross income in order to arrive at the net income taxable, and, therefore, subjecting the rent to double taxation, thus creating a direct discrimination or double taxation on those corporations which are required to keep their records according to the standard classification of accounting of the Interstate Commerce Commission.

Affiant is advised that only those corporations engaged in operating steam or electric railroads in transportation of passengers and property in Interstate Commerce, and pipe lines carrying certain commodities, and of intelligence, are required to keep records in accordance with the standard classification of accounting of the Interstate Commerce Commission, and therefore, as affiant is advised, informed, and believes, corporations that are engaged in Interstate Commerce in the manner above indicated are penalized for transacting
77 and carrying on interstate commerce.

Affiant is informed, believes and alleges that it is not the general rule that corporations operating railroads engaged in transporting freight and passengers in interstate commerce are financed almost entirely by bond issues.

Norfolk Southern Railroad Company is not financed in that way. As of December 31, 1921 the Company has outstanding capital stock of the par value of sixteen million dollars, and its funded debt was \$19,608,600.

Affiant avers that Moody's publication of the financial condition of industrial corporations is a standard authority for the financial condition of such corporations.

An examination of that publication issued for the year 1922 discloses that as to the corporations hereinafter named, which affiant is informed, believes and alleges were during the income tax year 1921, and are now, engaged in operating and doing business in the State of North Carolina, as to their relative capital stock issue and funded debt, and bills and accounts payable, as follows, to-wit:

Liggett & Myers Tobacco Co., capital stock \$55,188,300, funded debt \$29,320,600.

Royster Guano Company, capital stock \$2,473,800, and stock of subsidiaries \$331,800, funded debt \$2,500,000, bills and accounts payable \$4,252,175.00.

Virginia Carolina Chemical Company, capital stock \$18,652,972.00 bonds \$26,267,000, bills payable \$27,421,708, total of bonds and bills payable \$53,689,403.00.

Armour & Company, capital stock \$150,000,000.00 bonds \$115,560,900, bills payable \$129,198,913.00.

Consolidated Textile Corporation, capital stock \$26,452,195 with a foot note stating "representing capital, surplus and 801,039 shares of no par value." Bonded debt of \$12,500,000, bills and accounts payable \$14,706,360.00.

78 Affiant has not had access to Moody's publication as to public utilities for the year 1922, but such publication for the year 1921, as to public utility corporations, disclosed that as appears therein, the relative capital stock issue and bonded indebted-

ness of some of the public utility corporations, which as affiant is informed, believes and alleges, are not required to keep records in accordance with the standard classification of accounting if the Interstate Commerce Commission, were as follows:

Southern Power Company, capital stock ten million dollars, bonded debt seven million dollars.

Asheville Power & Light Company, of Asheville, N. C., capital stock \$1,639,700 bonded debt \$1,220,000.

Southern Public Utilities Company, capital stock six million dollars, underlying bonds \$1,773,500.00, 5% gold bonds \$4,487,700.

Affiant avers that the real and true difference in financing corporations operating railroads engaged in transporting passengers and property in interstate commerce on the one side and industrial corporations and public utility corporations on the other side, and the reason therefor, arose out of the legal restrictions which have from time to time been placed on and around such railroad corporations and from which industrial corporation- are free, i. e. such railroad corporations are not allowed to issue any bonds, stocks or securities except a limited amount of short term notes, until and only to the extent that the duly authorized governmental body shall after investigation find and certify that the issuance of such securities is for some lawful object within its corporate purposes and is compatible with the public interest and is necessary or appropriate and consistent with the proper performance of service to the public and will not impair the ability of such corporation to perform that service and is reasonably necessary for that purpose and after full and complete showing as to the terms upon which the securities are to be sold and the rate of interest they are to bear, while ordinary industrial corporations and many public utility corporations are allowed to issue and

sell their securities upon such terms and for such purposes as

79 to them may seem proper; that such railroad corporations are

by law prevented from accumulating out of earnings funds with which to discharge (except to a very limited extent) money borrowed to supply the necessary public service, unless such money can be borrowed at a much lower rate than has obtained in the money markets of the world in the last several years, and at a lower rate than the law allows such railroad corporations to earn upon the value of their property devoted to public use, to-wit: 5½ per cent, or unless such railroad corporations deprive the holders of their stock of the returns for the use of money invested in such capital, and devote the same, if earned, to the discharge of the principal of bonds or securities issued for the benefit of the public while ordinary industrial corporations are allowed to earn any rate of return which they can, so far as any inhibition of the law provides; that the corporations operating railroads transporting passengers and freight in interstate commerce may be compelled, under heavy penalties, to provide funds with which to furnish services to the public, or quit entirely, which they are not permitted to do, unless and until they have obtained authority so to do from governmental bodies, which authority may be issued only and to the extent that after such investigation the gov-

ernmental body finds that the public will not be unduly inconvenienced while industrail corporations are allowed to issue securities whenever they desire, or desist from issuing them, and if they so desire shut down and quit without leave of license from any person or governmental authority whatsoever.

That all the advantages of financing and paying off and discharging loans is with industrial corporations and the limitation of the law against corporations operating railroads transporting freight and passengers in Interstate commerce compel and require them to resort, as far as possible, to the borrowing of money upon long terms, and thus creating obligations which they would not have if the laws were so designed and enacted as to anable such corporations to sell their capital stock.

M. S. HAWKINS.

Sworn and subscribed to before me this 9th day of June 1922.

[Notarial Seal.]

J. R. PRITCHARD,

Notary Public.

My commission expires Jan. 10, 1925.

80

Affidavit of E. H. Kemper Without Exhibits.

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit of E. H. Kemper.

DISTRICT OF COLUMBIA,
City of Washington:

Personally appeared before me, a Notary Public, in and for the District of Columbia and City of Washington, E. H. Kemper, a resident of the City of Alexandria, State of Virginia, who, upon being duly sworn, deposes and says:

81
1. He is Comptroller of the Southern Railway Company and has occupied that position since June 7, 1918. Prior to that time, he had been General Bookkeeper, Assistant Auditor, Auditor and Assistant Comptroller of said Company since its organization in 1894; that he is thoroughly familiar with accounting.

2. He has read the Bill of Complaint and the Answer filed in this cause and the sections of the Income Tax Law of 1921 of North Carolina in reference thereto.

3. Affiant attaches hereto the Classification of Income Profit and Loss and General Balance Sheet accounts for Steam Railroads prescribed by the Interstate Commerce Commission, in accordance with Section 20 of the Act of Congress to Regulate Commerce, effective on July 1, 1914, and which is now and has been in effect since July 1, 1914, which said Classification is marked Exhibit "1."

4. Affiant also attaches hereto Classification of Operating Revenues and Operating Expenses of Steam Railroads prescribed by the Interstate Commerce Commission in accordance with Section 20 of an Act to Regulate Commerce effective July 1, 1914, and which has been in effect since that date and is now in effect, which said Classification is marked Exhibit "2."

82 5. Affiant also attaches as Exhibit "3" Page 301, Schedule 300 I, "Income Account for the Year," taken from the printed form of Annual Report to the Interstate Commerce Commission for the year ended December 31, 1921, which form is similar to that in effect since July 1, 1914.

6. Affiant further says that he is thoroughly familiar with the Classification of Accounts of the Interstate Commerce Commission, and has made a close study of them, and there is no such designation in the Classification of Accounts of the Interstate Commerce Commission as "net operating income."

7. Affiant further says that if under Section 202 of the Income Tax Act of 1921 of North Carolina the term, "net operating income" shall be construed to be the same as "net railway operating income," as that term is defined in Section 15 (a) of the Interstate Commerce Act, then the basis of arriving at the amount on which the North Carolina Income Tax is to be paid by a railroad whose business is wholly within the State differs from the basis prescribed for the Southern Railway, which operates partly within and partly without the State of North Carolina, in this: "Net railway operating income," as defined in Section 15 (a), is ascertained after deducting from gross operating income the accounts designated by the Interstate Commerce Commission as follows:

Account No. 537—Rent for Locomotives.

" " 538—Rent for Passenger Train Cars

" " 539—Rent for Floating Equipment.

" " 540—Rent for Work Equipment.

" " 541—Joint Facility Rents.

83 The Southern Railway Company, which operates partly within and partly without the State, is not allowed the above set forth deductions under the North Carolina Income Tax Law and therefore, the amount upon which the tax is paid is excessive and

criminary to the extent that said above set forth deductions are not allowed, and the amount of such excess is included and set forth in Exhibit "B" to the Bill filed in this case.

8. Affiant further states that in order to arrive at Southern Railway Company's "net income" from its records kept in accordance with the requirements of the Interstate Commerce Commission, it is entitled to deduct rents paid for property used in its operations from which revenue is derived and included in and forming a part of "railway operating revenues," the principal items of which are designated by the Interstate Commerce Commission under the following primary accounts:

Account No. 542—Rent for Leased Roads.

Under which account, as is shown by Exhibit "B" Southern Railway Company paid in the State of North Carolina for the year ended December 31, 1921, \$591,491.75, i. e.:

To the North Carolina Railroad Company an annual rental of	\$286,000.00
--	--------------

For lease to Southern Railway Company, under agreement dated August 16, 1895, that company's property, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues and under which operating agreement Southern Railway Company must pay all operating costs:	
---	--

Lessened in 1921, through credit as required under Classification of Interstate Commerce Commission by amount received as Southern Railway Company's equity in property sold	43,432.50
--	-----------

Leaving net charge as included in Account No. 542—Rent for Leased Roads—as included in Exhibit "B"	\$242,567.50
--	--------------

To the Atlanta and Charlotte Air Line Railway an annual rental of	\$1,128,000.00
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For lease to Southern Railway Company, under agreement dated March 26, 1881, that company's property extending from Charlotte, N. C., to Armour, Ga., under which agreement all operating revenues accrue	
---	--

to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs, of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

942,782.40

Leaving for North Carolina

185,217.60

To the North Carolina Midland Railroad Company an annual rental of ..

75,780.00

For lease to Southern Railway Company under agreement dated February 5, 1916, that company's property, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of railway operating revenues, and under which operating agreement Southern Railway Company must pay all operating costs:

To the Atlantic & Danville Railway Company an annual rental of

218,000.00

85 For lease to Southern Railway Company, under agreement dated August 31, 1899, that company's property, extending from Danville to Norfolk, and branches, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs; of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

200,625.40

Leaving for North Carolina

17,374.60

To Southern Railway—Carolina Division—an annual rental of

358,750.00

For lease to Southern Railway Company, under agreement dated June 30, 1902, that company's property extending from Kingville, S. C., to Marion, N. C., Charleston, S. C., to Savannah River near Augusta, Ga., Cayce, S. C., to Hardeeville, S. C.,

and branches, under which agreement all operating revenues accrue to Southern Railway Company and are included in its statement of Railway Operating Revenues, and under which operating agreement Southern Railway Company must pay all operating costs; of which annual rental there is assigned on the basis of a mileage division to States other than North Carolina

288,197.95

Leaving for North Carolina 70,552.05

The Southern Railway Company has not taken title, was not taking title, and has no equity in any of the above properties leased and which are all used in the conduct of its railroad business in North Carolina.

§ Account No. 543—Miscellaneous Rents.

Under which account affiant claims Southern Railway Company is entitled, as shown by Exhibit "B," in order to arrive at its "net income" in accordance with the Classification of Accounts of the Interstate Commerce Commission, to deduct for the year ended December 31, 1921, \$1,981.35, because it represents proportion of cost of miscellaneous property rented in North Carolina used in its operation.

9. Affiant further states that in order to arrive at Southern Railway Company's "net income" in accordance with its records kept under the requirements of the Interstate Commerce Commission, there should be added to its operating income the accounts designated by the Interstate Commerce Commission as:

- Account No. 504—Rent from Locomotives.
- " " 505—Rent from Passenger Train Cars.
- " " 506—Rent from Floating Equipment.
- " " 507—Rent from Work Equipment.
- " " 510—Miscellaneous Rent Income.
- " " 511—Miscellaneous Non-Operating Physical Property.
- " " 513—Dividend Income.
- " " 514—Income from Funded Securities.
- " " 515—Income from Unfunded Securities and Accounts.
- " " 519—Miscellaneous Income.

10. Affiant further states that after adding and deducting the foregoing items of revenues and expenses received and incurred in the

operation of Southern Railway Company, it has not, in accordance with the Standard Classification of Accounts of the Interstate Commerce Commission, under the provisions of the Interstate Commerce Act, reached its "net income" applicable to the State of North Carolina for the year ended December 31, 1921, until it has been allowed to deduct such items of expense incurred in the operation of Southern Railway Company in North Carolina as may be classified in its records under orders of the Interstate Commerce Commission as:

Account No. 545—Separately Operated Properties—Loss.

" " 546—Interest on Funded Debt.

" " 547—Interest on Unfunded Debt.

" " 548—Amortization of Discount on Funded Debt.

" " 549—Maintenance of Investment Organization.

" " 550—Income Transferred to Other Companies.

" " 551—Miscellaneous Income Charges.

Affiant says, when the above accounts are properly deducted, Southern Railway Company reaches its "net income" as designated under the Rules and Regulations and Classification of the Interstate Commerce Commission as is shown by page 301 taken from the annual report form of the Interstate Commerce Commission, attached hereto as Exhibit "3."

11. Affiant further says that Southern Railway Company is discriminated against in that under Section 306 of the Revenue Act of 1921, there is allowed to others as deductions before arriving at "net income" rentals, interest, and other deductions acknowledged to be incurred in connection with and as an offset to operating revenue or income, while no such deductions are allowed Southern Railway Company under Section 202, and Southern Railway Company has of such deductible items the amount shown on Exhibit "B;" and affiant further says that, under all rules of accounting, "net income" is as a fact that amount received by railroad corporations, after deducting from their gross income, all expenses of operating their properties, including rentals paid for the continued use or possession of their rented property in the business of transportation, together with interest paid on indebtedness, and such deductions are allowable in arriving at "net income" under the Federal Income Tax Act.

12. Affiant further says that under Section 303 of the North Carolina Revenue Act of 1921 there is allowed corporations other than railroads and public service corporations, deductions for debts ascertained to be worthless and charged off within the income year, and Southern Railway Company asserts that such debts written off during the year accrued in North Carolina amounted to \$26,196.97 as shown by Exhibit "C," and that Southern Railway Company should be allowed to deduct said item before arriving at the sum on which the tax is to be paid.

Affiant further says that, as will be seen from Exhibit "3" hereto, the Interstate Commerce Commission, in its classification of accounts, prescribes that there shall be deducted before arriving at net income Account No. 548—"amortization of discount on funded debt." The text of that account, as set forth by the Interstate Commerce Commission, is as follows:

"This account shall be charged during each fiscal period with the proportion of the discount and expense on funded debt obligations applicable to that period. This proportion shall be determined according to a rule the uniform application of which through the interval between the date of sale and the date of maturity will extinguish the discount and expense on funded debt. The charge to this account for any period must not be either greater or less than the proportion of the balance remaining unamortized applicable to that period so long as any portion of the discount and expense remains unextinguished. (See special instruction for balance sheet accounts, Section 3.)

"NOTE.—The accounting company may, at its option, charge to profit and loss account No. 617 'Debt discount extinguished through surplus,' all or any portion of the discount and expenses on funded debt remaining at any time unextinguished."

The Southern Railway Company has made no deduction under 548, but, as is allowed it under the note to account 548 above set forth, the Southern has an equivalent account known as No. 617, "Debt Discount Extinguished Through Surplus," the text of which is as set forth in the Interstate Commerce Commission Classification:

"This account shall include appropriations of surplus made, at the option of the accounting company, to reduce or extinguish the discount and expense on funded debt. See income account No. 548 'Amortization of discount on funded debt,' and balance sheet account No. 725 'Discount on funded debt.'"

Therefore, the Southern has deducted under the Interstate Commerce Commission's accounting rules the above referred to item 617, as shown in Exhibit "C" to the bill of complaint filed in this case. The amount thereof applicable to North Carolina is \$71,728.88, which it is extinguishing through surplus as provided for under the classification of the Interstate Commerce Commission before reaching its taxable net income.

Therefore, affiant asserts that the true "net income" of Southern Railway Company applicable to the State of North Carolina on which income tax should be paid is \$456,798.56, as shown by Exhibit "C."

13. Affiant further states that Southern Railway Company's "net income," in whole or that part applicable to the State of North Carolina, can only be reached on the basis of its records, and under the rules and regulations of the Interstate Commerce Commission, when there is taken into consideration those ac-

counts hereinbefore designated as additions to its revenues and deductions therefrom, as shown on Exhibit "3."

Affiant further states that the assessed value of Southern Railway Company's property in North Carolina certified to it by the Commissioner of Revenue of the State of North Carolina for the year 1921 was \$96,306,357.00; and the total ad valorem taxes which will have to be paid by Southern Railway Company to the tax subdivisions of the State of North Carolina, if said assessment remains, amounts to \$1,147,409.62.

In addition to the foregoing taxes, Southern Railway Company received from the Commissioner of Revenue an assessment of a franchise tax of one-tenth of one per cent on an assessed value of \$96,306,357.00, the amount demanded being \$96,306.35. If the income tax demanded is collected, Southern Railway Company will pay to the State of North Carolina and its subdivisions on its property and earnings for the year 1921 a total sum of \$1,315,238.03.

E. H. KEMPER.

Subscribed and sworn to before me, this 31st day of May, 1922.

[L. S.]

HARRY K. PIMPER,

Notary Public.

92

Affidavit of F. C. Harding.

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

F. C. Harding, being duly sworn, deposes and says, that he is the President of the Greenville and Shelberdine Railroad Company; that the same was chartered in 1920; that the road is 12 miles long, extending from Greenville to Shelberdine and is of narrow gauge. That W. L. Hall is the Secretary of said Railroad Company and that David Hoots is General Superintendent, Engineer and Conductor. That this road has no office, either in Greenville or at Shelberdine or along the route of its railroad. That this road makes, as a general thing, one trip a day.

During the movement of fertilizer in the spring, it often makes two trips a day. That it carries freight for hire, from Greenville to any point along the road to Shelberdine and from Shelberdine to any point along the road to Greenville. That it issues no bills of lading. That the freight it carries from Greenville to Shelberdine, or along the route, is removed from the Atlantic Coast Line Railroad Company cars and placed in this company's car and is delivered along

the route to its several patrons. That while people along the route use this road as a convenience to travel, this company has never charged any passenger rates. That this company has never made any report to the State Corporation Commission or to the Internal Revenue Commissioner and of course has never made any interstate report as it does not do any interstate business as all of its business is intrastate. That this road is not a lumber road. It was originally built for a lumber road but when the Beaufort County Lumber Co., removed from Pitt County, the road was purchased by the present owners who afterwards incorporated under the style above named.

93 Affiant further states that the Greenville and Shelberdine Railroad Company does not keep its accounts according to the standard classification of accounts promulgated by the Interstate Commerce Commission.

F. C. HARDING.

Subscribed and sworn to before me this 20th day of June 1922.

M. V. HARDING,
Notary Public.

My commission expires Nov. 3, 1922.

94 Affidavit of J. C. Nelms, Jr. (May 17, 1922).

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says: That he is General Auditor of Norfolk Southern Railroad Company that during the year 1921, Norfolk Southern Railroad Company operated a line of railroad owned by Carthage & Pinchurst Railroad Company, extending from Pinchurst to Carthage, North Carolina, under a lease which had expired, the reason for the continued operation thereof being that it had been prohibited by the laws of the United States to abandon said line of railroad unless permission was granted by the Interstate Commerce Commission;

That during the year 1921, it paid as rent for the use of said property in the business or trade of Norfolk Southern Railroad Company the rent stipulated to be paid in said lease.

That Norfolk Southern Railroad Company had not taken title to and was not taking title to said property, and had no equity therein.

5-756

J. C. NELMS, JR.

Subscribed and sworn to before me this 17th day of May 1922.

GILBERT C. REVEILLE,
Notary Public.

[SEAL.]

My commission expires on the 31st day of August, 1924.

95 *Affidavit of J. C. Nelms, Jr. (May 18, 1922).*

Filed June 20, 1922.

In the District Court of the United States for the Eastern District of
North Carolina.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Affidavit.

J. C. Nelms, Jr., being first duly sworn, deposes and says:

That he is a citizen and resident of the County of Norfolk, and State of Virginia; that he is General Auditor of Norfolk Southern Railroad Company and has occupied that position since April, 1913; that he is familiar with the rules of accounting for steam and electric railroads as prescribed by the Interstate Commerce Commission.

On the 19th of May, 1914, effective July 1, 1914, the Interstate Commerce Commission issued orders classifying the accounts of steam railroads, and dividing the accounts into two classes:

- (1) Operating Revenues and Operating Expenses; and,
- (2) Income, Profit and Loss, and General Balance Sheet Accounts.

These rules are still in force, subject to such modifications and explanations as have been made by the Commission since that date.

That the order prescribing the classification of Operating Revenues and Operating Expenses of Steam Roads, among other things provided:

"It is ordered, That, the Classification of Operating Revenues and Operating Expenses of Steam Roads and the text pertaining thereto embodied in printed form to be hereafter known as Issue of 1914, a copy of which is now before this Commission, be, and is hereby, approved; that a copy thereof duly authenticated by the Secretary of the Commission be filed in its archives, and a second copy thereof in like manner authenticated, in the office of the Division of Carriers' Accounts; and that each of said copies so authenticated and filed shall be deemed an original record thereof.

"It is further ordered, That the said Classification of Operating Revenues and Operating Expenses of Steam Roads, with the text pertaining thereto, be, and is hereby, prescribed for the use of carriers by rail (exclusive of electric railways) subject to the provisions of the Act to Regulate Commerce as amended, in the keeping and recording of their operating revenue and operating expense accounts; that each and every such carrier and each and every receiver or operating trustee of any such carrier be required to keep all operating revenue and operating expense accounts in conformity therewith; and that a copy of said issue be sent to each and every such carrier and to each and every receiver or operating trustee of any such carrier."

This affiant has a copy of the said order and the classification of accounts and instructions accompanying the same.

Accompanying said order, as sent to the carriers, was an introductory letter, which among other things stated that:

"Accounts are provided in this classification for the revenues and expenses of operations which heretofore have been classed as auxiliary or outside operations. The purpose in merging these accounts has been to secure a statement of revenues and expenses in connection with the operation of all physical property the cost of which is includible in the accounts for investment in road and equipment. The accounts for maintenance of physical property have been arranged to correspond with those for the investment in such property. Depreciation accounts have been provided for the current depreciation of fixed improvements, although until further directed the recognition in operation expenses of current depreciation of fixed improvements is optional with the carrier. It is provided that organization and general administration expenses directly assignable to investments in stocks, bonds, and other securities shall be excluded from the accounts of this classification and included in income account No. 549, "Maintenance of investment organization."

There also accompanied said order and classification certain general instructions, among which were the following:

"1. Operating Accounts.—The accounts of this classification are designed to show the revenues and expenses (including the maintenance of the facilities used) of the carrier's railway operations, including rail-line transportation, water-line transportation, if any, and services incident to transportation. Transportation includes the receipt, conveyance, and delivery of traffic."

"4. Miscellaneous Operations.—The revenue and expenses of miscellaneous operations involving the use of such facilities as hotels and restaurants, power plants, cold-storage plants, coal-storage plants, cotton compress plants, wood-preserving plants, ice-supply plants, etc., shall not be included in the accounts of this classification when the facilities used are distinct from those used by the carrier in the service of transportation or in the maintenance of facilities used in transportation service, and the operations are not

incident to such service. (See income accounts No. 502, "Revenue from miscellaneous operations," and No. 534, "Expenses of miscellaneous operations," and balance-sheet account No. 705, "Miscellaneous physical property.")"

There also accompanied said order certain special instructions, among which was:

"1. Accounts for Operating Revenues.—The accounts provided for operating revenues are designed to show amounts of money which a carrier becomes entitled to receive from transportation and from operations incident thereto."

The Operating Revenue accounts were by the said classification divided into general accounts and primary accounts. A statement of the general accounts and primary accounts for steam railroads, according to the said classification, showing the number of each account, as set out in said rule and order is hereto attached marked Exhibit A and prayed to be taken as a part of this affidavit.

The said order prescribed that account 142 "Rents of Buildings and other property," should include: "the revenue from the exclusive use of buildings and other property or portions thereof, such as depot and station grounds and buildings, general and other offices, wharves, ferry landings, elevators, stockyards, fuel yards, enginehouses, repair shops, and section and other houses, when the property is operated and maintained in connection with the property used in the carrier's transportation operations and the expenses of maintaining and operating the rented portion cannot be separated from the expenses of that portion used by the carrier."

As to the General Account No. IV, Joint Facility, being primary accounts Nos. 151 and 152, the said order provides that these accounts should include the carrier's proportion of revenue collected by others in connection with the operation of joint tracks, yards, terminals and other facilities, and also that proportion of revenue from the operation of joint tracks, yards terminals and other facilities, which is creditable to other companies.

The account did not include the rent paid for the use of the joint facilities, simply results of operations.

The operating expenses were by said order divided into eight general accounts, and into quite a number of primary accounts. A statement is hereto attached showing the general and primary accounts of steam railroads. Said statement is marked Exhibit B and is prayed to be taken as a part hereof.

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The special instructions accompanying said order, among other things, stated that: "The accounts prescribed for operating expenses are designed to show expenses of furnishing transportation service, including the expenses of maintaining the plant used in the service."

The accounts of Norfolk Southern Railroad Company are and have been kept in accordance with the rules and regulations prescribed by the Interstate Commerce Commission as set out in said orders, as

explained by the instructions and orders of the Commission, modifying or explaining the aforesaid order of May 19, 1914.

The said accounts and reports made to the Commission in accordance with said rules and regulations do not contain any such term as "Net Operating Income." The reports of Norfolk Southern Railroad Company made to the Interstate Commerce Commission show the total amount of its operating revenues and also shows the total amount of its operating expenses, and also the difference between these two amounts, which in said reports, and under the rules prescribed by the Interstate Commerce Commission, is denominated and known as "Net Revenue from Railway Operations." The Net Revenue from Railway Operations of Norfolk Southern Railroad Company and of corporations operating steam or electric railroads, keeping their accounts in accordance with the standard classification of accounting of the Interstate Commerce Commission, is the difference between the amount of money which Norfolk Southern Railroad Company or such other similar corporations, receives from transportation, as the term "Transportation" is defined in the said classification of accounts and in the Interstate Commerce Act, and the amount paid out for "all the ordinary and necessary expenses paid during the income year for conducting and carrying on transportation, as transportation is defined in the said classification of accounts and in the Interstate Commerce Act, including as a part of said expenses depreciation on its equipment, to-wit: steam locomotives, other locomotives, freight train cars, passenger train cars, motor equipment of cars, floating equipment, work equipment and miscellaneous equipment, if any."

Accounts of operating revenues and operating expenses of steam railroads, such as Norfolk Southern Railroad Company, and other similar corporations, kept in accordance with standard classification of accounting of the Interstate Commerce Commission do not include all gain derived from capital or labor or both combined, provided it is understood that the term "gain" includes profit gained through a sale or conversion of capital assets.

The said operating revenues and operating expenses of steam roads does not include the following items of gain or income which such corporations may receive during any period of time, but said items or sources of revenue or gain are in accordance with said classification carried under what is known as income accounts, to-wit: revenues from miscellaneous operations, hire of freight cars, credit balance, rents from locomotives, rents from passenger train cars, rents from floating equipment, rents from work equipment, joint facility rent income, income from lease of road, miscellaneous rent income, miscellaneous non-operating physical property, separately operated properties,—profit, dividend income, income from funded securities, income from unfunded securities and accounts, income from sinking and other reserve funds, release of premiums on funded debt, contributions from other companies, and miscellaneous income, all of which are gain from labor or capital or both combined, or from a sale or conversion of capital assets.

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The accounts of operating revenues and operating expenses of steam railroads, when such accounts are kept in accordance with the standard classification of accounting of Interstate Commerce Commission, do not include all of the expenses of conducting and carrying on the business of the corporation, and do not include many items of expenses which are necessary to be paid in order that the business may be carried on, to-wit: railway tax accruals; uncollectible railway revenues; expenses of miscellaneous operations; taxes on miscellaneous operating property; hire of freight cars—debit balance; rent for locomotives; rent for passenger-train cars; rent for floating equipment; rent for work equipment; joint facility rents; rent for leased roads; miscellaneous rents; miscellaneous tax accruals; separately operated properties—loss; interest on funded debt; interest on unfunded debt; amortization of discount on funded debt; maintenance of investment organization; income transferred to other companies; miscellaneous income charges; income applied to sinking and other reserve funds; dividend appropriations of income; income appropriated for investment in physical property; stock discount extinguished through income; and miscellaneous appropriations of income.

Under the aforesaid orders of the Interstate Commerce Commission dividing the accounts of corporations, operating steam railroads engaged in interstate commerce, into the two general classes as aforesaid, to-wit: Operating Revenues and Operating Expenses on the one part, and Income, Profit and Loss, and General Balance Sheet Accounts on the other, the Interstate Commerce Commission prescribed with great care and particularity the items of revenue which should go into each of the income accounts both credit and debit accounts.

A list of the primary accounts constituting the income accounts under said classification, both credit and debit is hereto attached, marked Exhibit C and prayed to be taken as a part hereof.

In addition, the said order of the Commission in prescribing rules of accounting for corporations operating steam railroads engaged in interstate commerce, prescribed a form of income statement. A copy of said form is hereto attached and made a part hereof, marked Exhibit D, and prayed to be taken as a part hereof.

100 The accounts of Norfolk Southern Railroad Company are kept in accordance with the aforesaid classification, its income statement is made to accord with the form of income statement prescribed in said rules of accounting and it reports to the Interstate Commerce Commission its operating revenues, operating expenses, other items of intake and outgo, all as prescribed by the Interstate Commerce Commission.

The term "Operation Ratio" does not appear in said rules of accounting. The term "operating ratio" is generally understood to mean and be that percent which the operating expenses as prescribed by the Interstate Commerce bears to the operating revenues as prescribed by the Interstate Commerce Commission.

The difference between the operating revenue and operating expenses of a corporation operating the steam railroads in keeping its accounts in accordance with the rules of the Interstate Commerce Commission does not show or purport to show the net income of such

corporations, but purports to show and shows the difference between the amount of revenue received from the business of conducting and carrying on its transportation and the operations incident thereto and the cost and expense of conducting such transportation and the incidents thereto.

In order to obtain the net income of such corporations it is necessary to consider and take into consideration the income accounts of said corporation as prescribed and shown in the rules of accounting of the Interstate Commerce Commission, and is set out in the form of income statement prescribed by the Commission, and which such railroad companies are required to make to the Commission.

Norfolk Southern Railroad Company owns and operates a line of electric railroad which runs from Norfolk to Virginia Beach and thence to Cape Henry, thence returning to Norfolk. In making reports to the Interstate Commerce Commission under the orders of the Commission the accounts of the electric division and the steam division are combined. Under permission granted by the Interstate Commerce Commission, Norfolk Southern Railroad Company keeps records showing the accounts of the electric division or electric railroad separate from the steam division or steam railroad. No part of the electric railroad is situated in North Carolina. The steam railroad extends and is situated both in North Carolina and Virginia. The ratio of operating expenses to operating revenue of the electric division was for the year 1921, 74.37% and for the steam division 84.51%, and for the entire system including both steam and electric divisions, 83.81%. That is to say that out of every dollar received by Norfolk Southern Railroad Company in payment for services rendered in the conduct of transportation on its electric division, as transportation is defined in classification of accounts of the Interstate Commerce Commission, it paid out in operating expenses, as

such operating expenses are defined in said classification of accounts, 74.37 cents. That on its steam division, which is located partly in North Carolina and partly in Virginia, where the business is both local and through, in both states, out of every dollar taken in for services rendered in the conduct of transportation, both intra and interstate, it became necessary to pay, and the company did pay in operating expenses as operating expenses are defined in said classification, the sum of 84.51 cents. That considering its entire system, both electric and steam, out of every dollar taken in payment for services rendered in transportation, both interstate and intrastate, as transportation is defined in the standard classification of accounting of the Interstate Commerce Commission, it becomes necessary for Norfolk Southern Railroad Company to pay for operating expenses in conducting transportation, as transportation is defined in the classification of accounting of the Interstate Commerce Commission 83.81 cents.

That in addition to the operating expenses aforesaid it became necessary for Norfolk Southern Railroad Company, in order to conduct and carry on its business and especially its business on steam division, to pay sums and items as set out in section 23 of the bill of complaint filed in this case.

During the calendar year 1921, which was the income year 1921, Norfolk Southern Railroad Company paid expenses for conducting and carrying on its business which are not included under the head of operating expenses under the rules of accounting of the Interstate Commerce Commission, as follows, to-wit:

Joint Facility Rents, that is rents for tracks, yards, terminals and other facilities owned or controlled by other carriers, companies or individuals, and in the joint use of which Norfolk Southern Railroad Company participated, in the sum of \$37,366.96 of which \$34,009.76 was allocatable to that part of the road located in North Carolina.

For rent of roads, tracks or bridges, including equipment and other railway property covered by the contract of lease of other companies held under lease or other agreement, by the terms of which the exclusive use and control for operating purposes are secured, the sum of \$160,365.96, the entire amount of which was for properties located in North Carolina.

For the use of miscellaneous property, that is property which was not used in the operation of the railroad, but used in the conduct of its business and necessary so to be used, the sum of \$1,376.63 of which \$372.83 was allocatable to North Carolina.

For interest on its funded debt the sum of \$884,399.57 of which \$778,351.22 was and is allocatable to the State of North Carolina.

For interest on unfunded debt \$37,025.96, of which \$32,587.06 is allocatable to North Carolina.

102 For amortization of discount on funded debt, being a proportion of the discount and expense on funded debt of the company applicable to that period, in accordance with the standard rules of accounting of the Interstate Commerce Commission \$24,719.53 of which \$21,755.41 was and is allocatable to North Carolina.

Other expenses of conducting and carrying on its business which, in the standard classification of accounting of the Interstate Commerce Commission is designated as miscellaneous income charges, the sum of \$57,697.34, of which \$50,778.85 is allocatable to the State of North Carolina.

That Norfolk Southern Railroad Company had not taken title, was not taking title, and had no equity in any of the properties leased including the railroads or joint facilities, and which are referred to as having been secured for its use in the conduct of its business by payment of the rents aforesaid.

That under the orders of the Commission, the form of accounting prescribed for operating expenses carried accounts "for the current depreciation of fixed improvements." The said orders and instructions further provided that the recognition of and charging out in operating expenses current depreciation of fixed improvements is and was optional with the carrier. Norfolk Southern Railroad Company has never charged out in its operating expenses any current depreciation for fixed improvements.

(S)

J. C. NELMS, JR.

Sworn and subscribed to before me this 18 day of May, 1922.

(S)
[SEAL.]

GILBERT C. REVEILLE,
Notary Public.

My commission expires on the 31st day of August, 1924.

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EXHIBIT A.

Operating Revenue Accounts.

General Accounts.

- I. Transportation—Rail Line.
- II. Transportation—Water Line.
- III. Incidental.
- IV. Joint Facilities.

Primary Accounts.

I. Transportation—Rail line:

- 101. Freight.
- 102. Passenger.
- 103. Excess baggage.
- 104. Sleeping car.
- 105. Parlor and chair car.
- 106. Mail.
- 107. Express.
- 108. Other passenger-train.
- 109. Milk.
- 110. Switching.
- 111. Special service train.
- 112. Other freight-train.
- 113. Water transfers—Freight.
- 114. Water transfers—Passenger.
- 115. Water transfers—Vehicles and live stock.
- 116. Water transfers—Other.

II. Transportation—Water line—

- 121. Freight.
- 122. Passenger.
- 123. Excess baggage.
- 124. Other passenger service.
- 125. Mail.
- 126. Express.
- 127. Special service.
- 128. Other.

III. Incidental—

- 131. Dining and buffet.
- 132. Hotel and restaurant.
- 133. Station, train, and boat privileges.
- 134. Parcel room.
- 135. Storage—Freight.
- 136. Storage—Baggage.
- 137. Demurrage.
- 138. Telegraph and telephone.
- 139. Grain elevator.
- 140. Stockyard.
- 141. Power.
- 142. Rents of buildings and other property.
- 143. Miscellaneous.

IV. Joint Facility—

- 151. Joint Facility—Cr.
- 152. Joint Facility—Dr.

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EXHIBIT B.

Operating Expense Accounts.

General Accounts.

- I. Maintenance of Way and Structures.
- II. Maintenance of Equipment.
- III. Traffic.
- IV. Transportation—Rail line.
- V. Transportation—Water line.
- VI. Miscellaneous operations.
- VII. General.
- VIII. Transportation for investment—Cr.

Primary Accounts.

I. Maintenance of Way and Structures—

- 201. Superintendence.
- 202. Roadway maintenance.
- 203. Roadway—Depreciation.
- 204. Underground power tubes.
- 205. Underground power tubes—Depreciation.
- 206. Tunnels and subways.
- 207. Tunnels and subways—Depreciation.
- 208. Bridges, trestles, and culverts.
- 209. Bridges, trestles, and culverts—Depreciation.
- 210. Elevated structures.
- 211. Elevated structures—Depreciation.
- 212. Ties.

213. Ties—Depreciation.
214. Rails.
215. Rails—Depreciation.
216. Other track material.
217. Other track material—Depreciation.
218. Ballast.
219. Ballast—Depreciation.
220. Track laying and surfacing.
221. Right-of-way fences.
222. Right-of-way fences—Depreciation.
223. Snow and sand fences and snowsheds.
224. Snow and sand fences and snowsheds—Depreciation.
225. Crossings and signs.
226. Crossings and signs—Depreciation.
227. Stations and office buildings.
228. Stations and office buildings—Depreciation.
229. Roadway buildings.
230. Roadway buildings—Depreciation.
231. Water stations.
232. Water stations—Depreciation.
233. Fuel stations.
234. Fuel stations—Depreciation.
235. Shops and enginehouses.
236. Shops and enginehouses—Depreciation.
237. Grain elevators.
238. Grain elevators—Depreciation.
239. Storage warehouses.
240. Storage warehouses—Depreciation.
241. Wharves and docks.
242. Wharves and docks—Depreciation.
243. Coal and ore wharves.
244. Coal and ore wharves—Depreciation.
245. Gas producing plants.
246. Gas producing plants—Depreciation.
247. Telegraph and telephone lines.
248. Telegraph and telephone lines—Depreciation.
249. Signals and interlockers.
250. Signals and interlockers—Depreciation.
251. Power plant dams, canals, and pipe lines.
252. Power plant dams, canals, and pipe lines—Depreciation.
253. Power plant buildings.
254. Power plant buildings—Depreciation.
255. Power substation buildings.
256. Power substation buildings—Depreciation.
257. Power transmission systems.
258. Power transmission systems—Depreciation.
259. Power distribution systems.
260. Power distribution systems—Depreciation.
261. Power line poles and fixtures.
262. Power line poles and fixtures—Depreciation.

- 263. Underground conduits.
- 264. Underground conduits—Depreciation.
- 265. Miscellaneous structures.
- 266. Miscellaneous structures—Depreciation.
- 267. Paving.
- 268. Paving—Depreciation.
- 269. Roadway machines.
- 270. Roadway machines—Depreciation.
- 271. Small tools and supplies.
- 272. Removing snow, ice and sand.
- 273. Assessments for public improvements.
- 274. Injuries to persons.
- 275. Insurance.
- 276. Stationery and printing.
- 277. Other expenses.
- 278. Maintaining joint tracks, yards, and other facilities—
Dr.
- 279. Maintaining joint tracks, yards, and other facilities—
Cr.

II. Maintenance of Equipment—

- 301. Superintendence.
- 302. Shop machinery.
- 303. Shop machinery—Depreciation.
- 304. Power plant machinery.
- 305. Power plant machinery—Depreciation.
- 306. Power substation apparatus.
- 307. Power substation apparatus—Depreciation.
- 308. Steam locomotives—Repairs.
- 309. Steam locomotives—Depreciation.
- 310. Steam locomotives—Retirements.
- 106 311. Other locomotives—Repairs.
- 312. Other locomotives—Depreciation.
- 313. Other locomotives—Retirements.
- 314. Freight-train cars—Repairs.
- 315. Freight-train cars—Depreciation.
- 316. Freight-train cars—Retirements.
- 317. Passenger-train cars—Repairs.
- 318. Passenger-train cars—Depreciation.
- 319. Passenger-train cars—Retirements.
- 320. Motor equipment of cars—Repairs.
- 321. Motor equipment of cars—Depreciation.
- 322. Motor equipment of cars—Retirements.
- 323. Floating equipment—Repairs.
- 324. Floating equipment—Depreciation.
- 325. Floating equipment—Retirements.
- 326. Work equipment—Repairs.
- 327. Work equipment—Depreciation.
- 328. Work equipment—Retirements.
- 329. Miscellaneous equipment—Repairs.

- 330. Miscellaneous equipment—Depreciation.
- 331. Miscellaneous equipment—Retirements.
- 332. Injuries to persons.
- 333. Insurance.
- 334. Stationery and printing.
- 335. Other expenses.
- 336. Maintaining joint equipment at terminals—Dr.
- 337. Maintaining joint equipment at terminals—Cr.

III. Traffic—

- 351. Superintendence.
- 352. Outside agencies.
- 353. Advertising.
- 354. Traffic associations.
- 355. Fast freight lines.
- 356. Industrial and immigration bureaus.
- 357. Insurance.
- 358. Stationery and printing.
- 359. Other expenses.

IV. Transportation—Rail line—

- 371. Superintendence.
- 372. Dispatching trains.
- 373. Station employees.
- 374. Weighing, inspection, and demurrage bureaus.
- 375. Coal and ore wharves.
- 376. Station supplies and expenses.
- 377. Yardmasters and yard clerks.
- 378. Yard conductors and brakemen.
- 379. Yard switch and signal tenders.
- 380. Yard enginemen.
- 381. Yard motormen.
- 382. Fuel and yard locomotives.
- 383. Yard switching power produced.
- 384. Yard switching power purchased.
- 385. Water for yard locomotives.
- 386. Lubricants for yard locomotives.
- 387. Other supplies for yard locomotives.
- 388. Enginehouse expenses—Yard.
- 389. Yard supplies and expenses.
- 390. Operating joint yards and terminals—Dr.
- 391. Operating joint yards and terminals—Cr.
- 392. Train enginemen.
- 393. Train motormen.
- 394. Fuel for train locomotives.
- 395. Train power produced.
- 396. Train power produced purchased.
- 397. Water for train locomotives.
- 398. Lubricants for train locomotives.
- 399. Other supplies for train locomotives.

- 400. Enginehouse expenses—Train.
- 401. Trainmen.
- 402. Train supplies and expenses.
- 403. Operating sleeping cars.
- 404. Signal and interlocker operation.
- 405. Crossing protection.
- 406. Drawbridge operation.
- 407. Telegraph and telephone operation.
- 408. Operating floating equipment.
- 409. Express service.
- 410. Stationery and printing.
- 411. Other expenses.
- 412. Operating joint tracks and facilities—Dr.
- 413. Operating joint tracks and facilities—Cr.
- 414. Insurance.
- 415. Clearing wrecks.
- 416. Damage to property.
- 417. Damage to live stock on right of way.
- 418. Loss and damage—Freight.
- 419. Loss and damage—Baggage.
- 420. Injuries to persons.

V. Transportation—Water line—

- 431. Operation of vessels.
- 432. Operation of terminals.
- 433. Incidental.

VI. Miscellaneous operations—

- 441. Dining and buffet service.
- 442. Hotels and restaurants.
- 443. Grain elevators.
- 444. Stockyards.
- 445. Producing power sold.
- 446. Other miscellaneous operations.

VII. General—

- 451. Salaries and expenses of general officers.
- 452. Salaries and expenses of clerks and attendants.
- 453. General office supplies and expenses.
- 108 454. Law expenses.
- 455. Insurance.
- 456. Relief department expenses.
- 457. Pensions.
- 458. Stationery and printing.
- 459. Valuation expenses.
- 460. Other expenses.
- 461. General joint facilities—Dr.
- 462. General joint facilities—Cr.

VIII. Transportation for investment—Cr.

EXHIBIT C.

Income Accounts.

Primary Accounts.

I. Credits:

501. Railway operating revenues.
502. Revenues from miscellaneous operations.
503. Hire of freight cars—Credit balance.
504. Rent from locomotives.
505. Rent from passenger-train cars.
506. Rent from floating equipment.
507. Rent from work equipment.
508. Joint facility rent income.
509. Income from lease of road.
510. Miscellaneous rent income.
511. Miscellaneous non-operating physical property.
512. Separately operated properties—Profit.
513. Dividend income.
514. Income from funded securities.
515. Income from unfunded securities and accounts.
516. Income from sinking and other reserve funds.
517. Release of premiums on funded debt.
518. Contributions from other companies.
519. Miscellaneous income.

II. Debits:

531. Railway operating expenses.
532. Railway tax accruals.
533. Uncollectible railway revenues.
534. Expenses of miscellaneous operations.
535. Taxes on miscellaneous operating property.
536. Hire of freight cars—Debit balance.
537. Rent for locomotives.
538. Rent for passenger-train cars.
539. Rent for floating equipment.
540. Rent for work equipment.
541. Joint facility rents.
542. Rent for leased roads.
543. Miscellaneous rents.
544. Miscellaneous tax accruals.
545. Separately operated properties—Loss.
546. Interest on funded debt.
547. Interest on unfunded debt.
548. Amortization of discount on funded debt.
549. Maintenance of investment organization.
550. Income transferred to other companies.
551. Miscellaneous income charges.
552. Income applied to sinking and other reserve funds.

- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.

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EXHIBIT D.

Form of Income Statement.

I. Operating income—

- 501. *Railway operating revenues.
- 531. *Railway operating expenses.
- *Net revenue from railway operations.
- 532. *Railway tax accruals.
- 533. *Uncollectible railway revenues.
- *Railway operating income.
- 502. Revenues from miscellaneous operations.
- 534. Expenses of miscellaneous operations.
- Net revenue from miscellaneous operations.
- 535. Taxes on miscellaneous operating property.
- Miscellaneous operating income.
- Total operating income.

II. Non-operating Income—

- 503. Hire of freight cars—Credit balance.
- 504. Rent from locomotives.
- 505. Rent from passenger-train cars.
- 506. Rent from floating equipment.
- 507. Rent from work equipment.
- 508. Joint facility rent income.
- 509. Income from lease of road.
- 510. Miscellaneous rent income.
- 511. Miscellaneous non-operating physical property.
- 512. Separately operated properties—Profit.
- 513. Dividend income.
- 514. Income from funded securities.
- 515. Income from unfunded securities and accounts
- 516. Income from sinking and other reserve funds.
- 517. Release of premiums on funded debt.
- 518. Contributions from other companies.
- 519. Miscellaneous income.
- Total non-operating income.
- Gross income (or loss).

III. Deductions from gross income:

- 536. Hire of freight cars—Debit balance.
- 537. Rent for locomotives.

*Includes operations of water lines, if any.

- 538. Rent for passenger-train cars.
- 539. Rent for floating equipment.
- 540. Rent for work equipment.
- 541. Joint facility rents.
- 542. Rent for leased roads.
- 543. Miscellaneous rents.
- 544. Miscellaneous tax accruals.
- 545. Separately operated properties—Loss.
- 546. Interest on funded debt.
- 111 547. Interest on unfunded debt.
- 548. Amortization of discount on funded debt.
- 549. Maintenance of investment organization.
- 550. Income transferred to other companies.
- 551. Miscellaneous income charges.
- Total deductions from gross income.
- Net income (or loss).

IV. Disposition of Net Income:

- 552. Income applied to sinking and other reserve funds.
- 553. Dividend appropriations of income.
- 554. Income appropriated for investment in physical property.
- 555. Stock discount extinguished through income.
- 556. Miscellaneous appropriations of income.
- Total appropriations.
- Income balance transferred to credit (or debit) of Profit and Loss.

112 *Affidavit of J. C. Nelms, Jr. (June 12, 1922).*

Filed June 20, 1922.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS et al.

J. C. Nelms, Jr., being first duly sworn, deposes and says: that: Accompanying and constituting a part of the order of the Interstate Commerce Commission, made the 19th day of May, 1914, effective July 1st, 1914, and still in force, with such modifications and amendments as may have been made thereto, were certain special instructions of which No. 1 reads as follows:

"Income accounts are those designed to show, as nearly as practicable, for each fiscal period, the total amount of money that a carrier

becomes entitled to receive for services rendered, the returns accrued upon investments, the accrued costs paid or payable for the services rendered by it, the losses sustained by it, the amounts accrued for taxes, for use of moneys and for use of properties of others, and the appropriations made from income during the period. The net balance of income (or loss) shall be carried to Profit and Loss."

The order above referred to is the order of the Commission regulating the keeping of records by Interstate Carriers by Railroad, known as "Classification of Income, Profit and Loss, and General Balance Sheet Accounts for Steam Roads."

J. C. NELMS, JR.

Sworn and subscribed to before me this 12th day of June, 1922.

[SEAL.]

GILBERT C. REVEILLE,
Notary Public.

My commission expires the 31st day of August, 1924.

113 *Tender of Amount Admitted to be Due.*

Filed June 20, 1922.

June 3, 1922.

Hon. A. D. Watts,
Commissioner of Revenue of North Carolina,
Raleigh, North Carolina.

DEAR SIR:

I respectfully herewith make a return of the Southern Railway Company's net income for the calendar year 1921. You will note that this return is not made in accordance with the form prescribed by the State Department of Revenue. It shows, we respectfully submit, the true net income for the year 1921, and is made up in accordance with the Interstate Commerce Commission's Classification of Accounts.

I herewith tender check for the amount of the income tax based on said return, namely, three per cent on \$456,798.56, amounting to \$13,703.95. If you decline to accept this because of the tender of the check not being legal tender, I advise that I will procure you United States Government funds should you so desire.

I further respectfully offer to pay, when advised by you of the amount thereof, any interest or penalties that may be due on account of non-payment of said income tax prior to this date.

Yours very truly,

S. R. PRINCE,
General Solicitor.

114 *Declination of the Commissioner of Revenue to Receive Tender.*

Filed June 20, 1922.

State of North Carolina.

Department of Revenue.

A. D. Watts, Com.,

Raleigh, N. C.

Mr. S. R. Prince, General Solicitor,
Southern Railway System,
1300 Pennsylvania Ave.,
Washington, D. C.

June 5th, 1922.

DEAR SIR:

I acknowledge receipt of your letter of the 3rd enclosing return of the Southern Railway Company's net income for the calendar year 1921, which return is not made in accordance with form prescribed by this Department, together with tender of check of \$13,703.95, covering income tax in full less any interest or penalties which may have accrued, based on such return.

I am returning you this return and check, as the net income of the Southern Railway Company for the calendar year 1921 is not determined in accordance with the provisions of Section 202 of the income tax act, prescribing the method of determining net income for railroad companies.

Yours very truly,
(Signed)

A. D. WATTS,
Commissioner.

O. S. T.: M. B.

115 *Testimony of R. O. Self at Hearing Before Judge Connor.*

It is agreed that all affidavits filed in the cause by either of the plaintiffs or by the defendants will be treated as in evidence in all cases.

Mr. R. O. Self, Clerk of the North Carolina Corporation Commission produced a list of the corporations operating as limited common carriers in North Carolina under authority granted by the State Corporation Commission under section 3413 of the Consolidated Statutes of North Carolina. Also a memorandum adding two other roads was attached, all filed as Exhibit A.

R. O. SELF, witness for the defendant, examined by Judge Manning, testifies as follows:

"That the several roads mentioned in Exhibit A were lumber roads, for logging purposes, operating under Section 3413 of the Consolidated Statutes as a limited carrier, with the right to stop at any-time."

Office of the Corporation Commission.

STATE OF NORTH CAROLINA:

This is to certify, that the Corporation Commission of North Carolina, acting under power vested in it by Sec. 3413 of the Consolidated Statutes of North Carolina, has granted authority to the corporations named below to conduct and carry on the business of limited common carriers between the points designated as to each of the corporations named, and that said corporations have filed with the Corporation Commission of North Carolina tariffs establishing the rate of charges which they are authorized to make for the transportation of commodities between the points named.

The corporations named and the points between which they are authorized to act as limited common carriers, engaged in Intra-state Commerce in North Carolina over a line of steam railroad, are as follows:

Andrews Manufacturing Company, Between Andrews and Old Road Gap, a distance of 8 miles, of thereabouts.

Carr Lumber Company, Between Pisgah Forest and Vanderbilt Boundary, a distance of about 20 miles.

Empire Manufacturing Company, Between Oliver Station to within three miles of Bentonville, about 13 miles.

Enterprise Lumber Company, Between Mount Olive and New Camp, a distance of 18 miles, or thereabouts.

Fishing Creek Timber & Railroad Company, Between Stamper, N. C., and Coffield's Bridge, about 10 miles.

Carolina Southern Railroad, Between Hollister and Vaughan, a distance of 14½ miles, or thereabouts.

Montgomery Lumber Company, Between Spring Hope and Bunn, N. C., a distance of 10 miles or thereabouts.

Ocona Luffy Railroad Company, Between Ocona Luffy, N. C., and Smokemont, N. C., about 10 miles.

117 Rowland Lumber Company, Between Bowdens, N. C. and

Warsaw, N. C., toward Newton Grove, a distance of about 20 miles.

Waccamew Lumber Company, Between Bolton and Makatoka, a distance of about 18 miles.

Weldon Lumber Company, Between Weldon, N. C., and a point near Ringwood, a distance of about 20 miles.

Whiteville Lumber Company, Between Whiteville, N. C., and Buttler, a distance of about 27 miles.

Mill Creek Valley Railroad Between — and — a distance of about — miles.

Suncrest Lumber Co., Sunburst to Canton.

Hilton Railroad & Lugging Co., Hilton Creek to Island Creek, 6 miles.

Done at the office of the Corporation Commission, at Raleigh, on this the — day of May 1922, by the Corporation Commission.

through W. T. Lee, its Chairman, and under the seal of the said Commission.

118 *Testimony of C. J. Joseph at Hearing Before Judge Connor.*

C. J. Joseph, Tax Agent of the A. C. L. Railroad, witness for the plaintiff, examined by Mr. Thomas W. Davis, testifies as follows:

"That he had for a great many years been the tax agent of that road, with the duty of checking and looking after all the taxes of that Company and its affiliated lines in Virginia, North and South Carolina, Georgia, Florida and Alabama. That he was familiar with this litigation and with the Income Tax Laws of North Carolina: that he has to keep up with the stocks and bonds and statistics of the various roads mentioned; that he is familiar with the commercial and financial Chronicle, a financial trade paper, circulated throughout the United States, that collects roads and industrial corporations and their stocks and bonds. The issue of May 27, 1922, of that paper was offered in evidence, and Mr. Davis desired to read into the record the capital stock and bonds of certain industrial corporations reporting to the North Carolina Tax Commission, the Tax Commission showing the capital, but not the bonds issued by them.

119 EXHIBIT TO TESTIMONY OF C. J. JOSEPH.

Representative Partial List of Industrial Corporations Doing Business in North Carolina and Reporting to the North Carolina Corporation Commission and Commissioner of Revenue Financed by Bonds and Stocks.

American Agricultural Chemical Company:

Common stock	\$33,322,126
Preferred Stock	28,455,200
First Mortgage bonds	6,252,000
1st Ref. Mortgage s. f. gold bonds, Series "A" ..	30,000,000

American Sugar Refining Company:

Common Stock	45,000,000
Preferred Stock	45,000,000
15 Year Gold Bonds	30,000,000

American Tobacco Company:

Common Stock "A"	40,242,400
Common Stock "B"	49,344,200
Preferred Stock	52,699,700
Gold Bonds	371,950
Gold Bonds & Cons, Tobacco Collateral Trust	
Trust Mortgage Bonds	1,365,300
Series of Gold Notes	10,000,000
8% Dividend Certificates	8,058,834

Dupont, I. E., de Nemours & Company:

Common stock	63,378,300
Debenture Stock	71,243,250
10 Year Gold Bonds	35,000,000

Galena Signal Oil Company:

Common Stock	16,000,000
Preferred Stock	2,000,000
New Preferred Stock	4,000,000
Convertible Debenture	6,000,000
Entire Stock of Subsidiary Companies.....	2,800,000
Galena Signal Oil of Texas Bonds	2,800,000

General Electric Company:

Common Stock	176,329,100
Debenture for Sprague Stock	2,047,000
Debenture	15,136,500
Debenture Bonds	15,000,000

120 Kelly Springfield Tire Company:

Common Stock	\$9,096,000
Preferred Stock	3,137,100
Second Preferred	5,625,200
10 Year s. f. Gold Notes	10,000,000

Morris Company:

1st Mortgage	17,626,000
10 Year s. f. Gold Notes.....	15,000,000
Wm. F. Mosser Co. 10 yr. s. f. notes	3,000,000

Swift & Company:

Common Stock	150,000,000
1st Mortgage s. f. Gold Bonds	28,923,500
Gold Notes	65,000,000

Texas Company:

Stock	164,450,000
3 yr. S. F. Notes	22,772,000

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Final Decree.

Filed Nov. 13, 1922.

In the District Court of the United States for the Eastern District of
North Carolina, Raleigh Division.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS and A. D. WATTS, as Commissioner of Revenue, and
JAMES S. MANNING, Attorney General of North Carolina.

Decree.

This is a suit in equity, brought by plaintiff, Southern Railway Company, a corporation chartered and organized under the laws of the State of Virginia, operating a line of railway in and through the State of North Carolina and the Eastern District thereof, against defendant, A. D. Watts, individually, and as Commissioner of Revenue of North Carolina and James S. Manning, Attorney General of said State, seeking an injunction restraining and enjoining said defendants from taking or causing to be taken any action toward enforcing the filing of a return or the collection of a tax or any part thereof, imposed, or sought to be imposed, by the State of North Carolina upon the plaintiff, under or by virtue of the provisions of the Public Laws of North Carolina of 1921, Chapter 34, known as the Revenue Act or the Income Tax Act, as amended by the General Assembly of North Carolina at its Special Session of 1921.

122 Following the service of process on the defendants and filing answer to the bill, the cause was set down for hearing upon the bill, answer and evidence.

Plaintiff alleges that, by the provisions of Article 5, Section 3 of the Constitution of North Carolina, the General Assembly is authorized to pass laws.

"Taxing, by a uniform rule, all moneys, credits, investments in bonds, stocks, joint-stock Companies, or otherwise, and also real and personal property, according to its true value in money. * * * The General Assembly may also tax trades, professions and incomes. Provided the rate of tax on incomes shall not, in any case, exceed six per cent, and there shall be allowed the following exemptions, to be deducted from the amount of annual incomes to-wit: For a married man, with a wife living with him, or to a widow or widower having minor child or children, natural or adopted, not less than \$2,000.00; to all other persons not less than \$1,000.00; and there

may be allowed other deductions (not including living expenses), so that only net incomes are taxed."

Pursuant to the provisions of the foregoing Art. of the Constitution, the General Assembly, at its Session of 1921, enacted a Statute providing for levying, collecting and paying an income tax on individuals and corporations. Chap. 34 Public Laws of North Carolina and known as a part of the Revenue Act of 1921, so far as it relates to the Income Tax as the "Income Tax Act of 1921."

The sections of this Act pertinent to the questions presented for decision by the plaintiff's contention are:

Section 101. Purpose.—

123 "The general purpose of this Act is to impose a tax for use of the State Government, upon the net income for the calendar year 1921, in excess of exemptions herein set out, collectible in the year 1922 and annually thereafter:

(a) Of every citizen of the State.

(b) Of every domestic corporation.

(c) Of every foreign corporation and of every non resident individual having a business or agency in this State in proportion to the net income of such business or agency.

"Except as otherwise provided in this act, the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority in so far as they apply."

"The tax imposed upon the net income of corporations in this Schedule is in addition to the tax imposed under Schedule "C" of this Act."

Section 201. Corporations.—

Every corporation organized under the laws of this State shall pay annually an income tax equivalent to three percent of the entire net income of such corporation, as herein defined, received by such corporation during the income year; and every foreign corporation doing business in this State shall pay annually an income tax equivalent to three per cent of a proportion of its entire net income, to be determined according to the following rules.

In case of a company or companies mentioned in the next succeeding section, deriving profits principally from the ownership sale or rental of real estate or from the manufacture sale, or use of tangible personal property, such proportion of its entire net income as the fair cash value of its real estate and tangible personal property, in this State, on the date of the close of the fiscal year of such company in the income year is to be the fair cash value of its entire real estate and tangible personal property then owned by it, with no deduction on account of incumbrances thereon.

124

In case of a corporation deriving profits principally from the holding or sale of intangible property such proportion as its gross receipts in this State for the year ended on the date of the close of its fiscal year next preceding is to its gross receipts for such year within and without the State.

"Section 202. Railroads and public service corporations.—

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporations as shown by their records kept in accordance with that Standard Classification of Accounts, when their business is wholly within this State and when their business is in part within and in part without this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of operating expenses' or 'operating ratio', for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts. From the net operating income thus ascertained shall be deducted 'uncollectible revenue,' and taxes paid in this State for the income year, other than income taxes and war profits and excess profits taxes, and the balance shall be deemed to be their net income taxable under this act."

The foregoing section relating to the basis of ascertaining the net income of railroads was supplemented by Chapter 35 of the Public Laws of 1921, as follows:

"Sec. 1. That in determining the taxable income of a corporation engaged in the business of operating a railroad under section two hundred and two of the act to raise revenue, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car hire."

Section 203 of the Income Tax Act of 1921, as amended by Chapter 35, Public Laws of 1921, is as follows:

"Section 203. Such tax shall first be levied, collected and paid in the year 1922, and with respect to the net income received during the calendar year 1921, and annually thereafter."

126 Section 3 of Chapter 34, Public Laws of 1921, provides:

"No tax on any property in the State shall be levied for any of the uses of the State Government. The taxes hereinafter levied in this act are for the expenses of the State Government, the appropriations to its educational, charitable and penal institutions, pensions for Confederate Soldiers and widows, the interest on the debt of the State, an equalizing fund for public schools, and other specific appropriations made by law, and shall be collected and paid into the general fund of the State Treasurer."

"Section 306. Deductions.—In computing net income there shall be allowed as deductions:

"1. All the ordinary and necessary expenses paid during the income year in carrying on any trade or business, including:

"(a) As to individuals, wages of employees for services actually rendered in producing such income.

"(b) As to partnerships, wages of employees and a reasonable allowance for co-partners or members of a firm, for services actually rendered in producing such income, the amount of such salary allowance to be included in the personal return of the co-partner receiving same.

"(c) As to corporations, wages of employees and salaries of officers, if reasonable in amount, for services actually rendered in producing such income.

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

127 "3. All interest paid during the income year on indebtedness except interest on obligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest.

"4. Taxes for the income year, except taxes on income and war profits, and excess profits taxes, inheritance taxes, and taxes assessed for local benefit of a kind tending to increase the value of the property assessed.

"5. Dividends from stock in any corporation the income of which shall have been assessed and the tax on such income paid by the corporation under the provisions of this act: Provided, that when only part of the income of any corporation shall have been assessed under this *this* act only a corresponding part of the dividends received therefrom shall be deducted.

"6. Losses sustained during the income year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit.

"7. Debts ascertained to be worthless and charged off within the income year, if the amount has previously been included in gross income in a return under this act.

"8. A reasonable allowance for the depreciation and obsolescence of property used in the trade or business; and, in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion: Provided, that in computing the deductions allowed under this paragraph, the basis shall be the cost (including in the case of mines, oil and gas wells, and other natural deposits, the cost of development, not otherwise determined) and in the case of property acquired prior to January 1, 1921, the fair market value of the property (or the taxpayer's interest therein) on that rate shall be taken in lieu of cost up to that date. The reasonable allowances under this paragraph shall be made under rules and regulations to be prescribed by the Tax Commission. In the case of leases the deductions allowed may be equitably apportioned between the lessor and lessee.

"9. In the case of taxpayers who keep regular books of account, upon an accrual basis and in accordance with standard accounting practice, reserves for bad debts and for contingent liabilities, under such rules and restrictions as the Tax Commission may impose. If the Tax Commission shall, at any time, deem the reserve excessive in amount, it may restore such excess to income, either in a subsequent year or as a part of the income of the income year and assess it accordingly.

"10. Contributions or gifts made within the taxable year to corporations or associations operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which enures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's net income as computed without the benefit of this subdivision.

"11. Resident individuals having an established business in another State, or investment in property in another State, may deduct the net income from such business or investment, if such business or investment is in a State that levies a tax upon such net income. The deductions authorized in this subsection shall in no case extend to any part of income of resident individuals from personal services, or mortgages, stocks, bonds, securities and deposits.

"12. In the case of a non-resident individual, the deductions allowed in this section shall be allowed only if, and to the extent that, they are connected with income arising from sources within the State; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the State shall be determined under rules and regulations prescribed by the State Tax Commission."

Complainant is engaged in operating an interstate railroad and keeps its accounts in accordance with the Standard Classification of

Accounts prescribed by the Interstate Commerce Commission and is required to pay an income tax under the appropriate part of Section 202 of the Income Tax Act or suffer the penalties prescribed in said Act.

Complainant respectfully shows the Court that the said Act is void as to complainant for the following reasons:

(a) Article 5, Section 3 of the Constitution of North Carolina authorizes the levy of a tax upon net incomes, and the statutory method prescribed in Section 202 for complainant and like corporations in order to arrive at net income results in the tax being levied on a sum which is not in truth and in fact net income, but includes a part of complainant's operating revenue in this:

Section 202 provides that railway corporations in the class of complainant shall first arrive at gross operating revenue within the State of its interstate business, and from this gross revenue shall deduct the following items:

130 (1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of car hire.

Plaintiff alleges that defendants, unless restrained by order of this Court, will, pursuant to the provisions of the Statutes in force in the State of North Carolina, levy upon and assess against it the income taxes for the year 1922 and certify such levy and assessment to the officers charged with the enforcement and collection thereof, amounting to a large sum in excess of \$3,000.00, to-wit the sum of \$71,522.06, whereas its true income tax should not be in excess of \$13,703.95, and that, unless said taxes are paid within the time fixed by the Statute, plaintiff will be subjected to heavy penalties and that the levy of such taxes will constitute a lien upon its property and thereby a cloud upon its title thereto, and that plaintiff will suffer other and irreparable damage etc., all of which will appear by reference to the allegations set out in its bill herein. The plaintiff's bill seeking an injunction, restraining defendants in the discharge of the official duties imposed by the Statute, is based upon the allegation that the sections of the Revenue Act of 1921, and especially upon those sections known as the "Income Tax Act" violate the Constitution of the State of North Carolina and of the United States for that among other reasons:

131 1st. The tax levied as directed by said Statute is not a tax on net incomes but is levied upon gross income, or real operating income and hence is repugnant to the State Constitution and to the Commerce Clause of the Federal Constitution.

2nd. The classification made by Section 202 of the Act, as to method of ascertainment of net income for plaintiff and other corporations within the designed class is arbitrary, without reasonable or practical basis and hence is repugnant to the Uniformity Clause, Art. 5, Sec. 3 of the State Constitution and the Equal Protection Clause of the Fourteenth Amendment to the Constitution of the United States.

That it is a violation of the State Constitution for the general property tax to be devoted to local purposes and the various exercise, privilege, franchise and income taxes to be devoted to State purposes.

That the income tax is invalid because it is levied in addition to property and franchise taxes. That the method of ascertaining the taxable income of plaintiff fixed or prescribed by Section 202 of the Act violates the provisions of Art. 5, Sec. 3 of the State Constitution and of the Fourteen- Amendment to the Federal Constitution, for that such method is not applied to such railroads or other public service corporation which do not operate their properties but have income only from rentals paid them by other companies to whom they lease their entire properties to be operated by the lessees.

It is pertinent, in view of the questions presented by the bills and answers and the prayer for injunctive relief to note the provisions of Section 700-701 of the Income Tax Act as amended by the 132 Act of 1921 creating the office known as Commissioner of Revenue, providing for and prescribing the procedure in applications for revision and appeal from assessments and levies of taxes against all persons or corporations having property in, or being liable for, tax in the State.

The Legislature, at its Special Session of 1921, made further provisions for refunding any taxes of any kind which have been through clerical error or misinterpretation or otherwise, collected or paid into the State Treasury in excess of the amount legally due the State and directing the State Auditor to issue his warrant for the amount so illegally collected to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney General and the Treasurer to pay the sum out of any funds in the Treasury not otherwise appropriated.

Upon consideration of the bill and answer Exhibits and evidence it is

Adjudged and decreed that plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the Statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against plaintiff. That the bill be dismissed. That defendants recover their cost to be taxed by the Clerk.

This the 7th day of November, 1922.

At Wilson, North Carolina.

H. G. CONNOR,
U. S. District Judge.

Order Granting Thirty Day Stay.

Filed Nov. 18, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, as Commissioner of Revenue of North Carolina, and Others.

Income Tax Suit.

It is ordered that the defendants shall not proceed to enforce the collection of taxes involved in this litigation for the period of thirty days from the date of this order, to the end that complainant may take such action in the premises as it is advised to.

Dated at Wilmington, North Carolina this the 17th day of November, 1922.

H. G. CONNOR,
U. S. Judge.

Notice of Appeal and Acceptance of Service.

Filed Dec. 7th, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als.
Defendants.

Notice of Appeal.

To the defendants in the above-entitled action and Honorable James S. Manning, Attorney General of North Carolina, and Frank Nash Assistant Attorney General, Solicitors for defendants:

You will please take notice that, on Wednesday, December 13th 1922, at 10.00 o'clock A. M., or as soon thereafter as counsel may

be heard, the above named plaintiff will apply to his Honor, Henry G. Connor, District Judge, at the United States Court Room, Raleigh, N. C., for an order allowing plaintiff to appeal to the Supreme Court of the United States in the above cause and granting a stay of proceedings until the appeal shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SOUTHERN RAILWAY COMPANY,
By W. M. HENDREN,
Attorney.

Service accepted this 7 day of December, 1922.

JAMES S. MANNING,
*Attorney General of North Carolina
and Solicitor for Defendants.*

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Assignment of Errors.

Filed Dec. 13, 1922.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina et als.,
Defendants.

Assignments of Errors.

Now comes the plaintiff in the above entitled cause and, in connection with its petition for appeal from the decree entered November 13th, 1922, denying the application for a permanent injunction, files the following assignments of error:

The Court erred:

1. In decreeing that, upon consideration of the bill and answer, exhibits and evidence, plaintiff is not entitled to have the defendants or either of them enjoined and restrained from the performance of the duties imposed upon them by the statutes of North Carolina relating to the administration, assessing, levying and enforcement or collection of the income tax against the plaintiff.
2. In failing to hold that the plaintiff is entitled to the injunction prayed for in the bill of complaint, for that the income tax at-

tempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is in violation of the Constitution of North Carolina and the Constitution of the United States, creates a discrimination against plaintiff and other railroad companies of similar character in favor of other corporations and individuals in that the said act in order to ascertain the taxable income allows other corporations and individuals certain deductions, many of which said deductions are not allowed to plaintiff and other railroad corporations of similar character.

3. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because, under the provisions of the Income Tax Act of 1921, and particularly Section 202, Section 300 and Section 306, all corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are required to pay a tax on their net income, which is defined by Section 300 as "the gross income of a taxpayer, less the deductions allowed by this act," whereas plaintiff and other railroads and public service corporations which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, are not allowed the deductions set forth in the said act, except "uncollectible revenue" and taxes paid in the State for the income year other than income taxes, war profits and excess profits taxes, and certain deductions for car hire, and plaintiff and other railroad companies and public service corporations of similar character referred to in Section 202 of the Income Tax Act of 1921 are denied large deductions which are granted other corporations, individuals and railroads not included in the provisions of Section 202, and particularly the deduction of interest paid during the income year, which results in discrimination against the plaintiff, in violation of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

4. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act does not operate equally and uniformly upon all taxpayers in similar circumstances, and that the plaintiff and other railroads and public service corporations, which are required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, have been arbitrarily selected and taxed upon a more burdensome basis and one that is different from that applied to corporations in general and to other corporations engaged in business similar to that of plaintiff, in violation of the Constitution of North Carolina and plaintiff is thereby denied

the equal protection of the law and is deprived of its property without due process of law in contravention of the Fourteenth Amendment of the Constitution of the United States.

5. In failing to hold that the plaintiff is entitled to an injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said tax is not levied by a uniform rule as required by the Constitution of North Carolina, Article 5, Section 3, and the lack of uniformity works greatly to the detriment of plaintiff, in violation of said Article 5, Section 3, of the Constitution of North Carolina, and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

6. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the classification of taxpayers for the purpose of fixing the income on which the tax shall be paid as made by the said Income Tax Act of 1921 is not based upon any reasonable ground, but is a mere arbitrary selection so far as plaintiff and railroad companies of similar character are concerned and so far as the corporations set forth in Section 202 are concerned, and was made for the purpose and has the result of imposing upon such railroad companies and corporations, including plaintiff, an unjust burden of taxation, in violation of the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

138 7. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the method of fixing plaintiff's taxable income as provided by Section 202 of the said Income Tax Act of 1921 violates the Constitution of North Carolina and the Constitution of the United States because it does not apply to railroads and public service corporations which derive their income from sources other than the operation of their property, which results in a lack of uniformity in the application of the income tax and in discrimination against plaintiff, and therein denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

8. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax at-

tempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void, because the authority of the Legislature of North Carolina to tax incomes is derived from Section 3, Article 5, of the Constitution of North Carolina, and said section provides that only net incomes may be taxed, and in attempting to tax the "operating revenues" of plaintiff, the said act violates the Constitution of North Carolina and denies the plaintiff the equal protection of the law and deprives it of its property without due process of law, in contravention of the Fourteenth Amendment of the Constitution of the United States.

9. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act is violative of Article 5, Section 3, of the Constitution of

North Carolina, for that it does not levy upon railroads and
139 other public service corporations named in said Section 202,

a tax on net income, but levies a tax upon operating revenues derived from interstate and intrastate commerce, and does not permit the deductions necessary and incidental to the business of plaintiff and expended by it from said income in order to determine net income, and is in violation of the Interstate Commerce Clause (Section 8, Article 1) of the Constitution of the United States, in that it permits a tax as an income tax to be placed on gross income derived from interstate commerce, thereby burdening interstate commerce.

10. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because said act violates the Transportation Act of Congress and the Interstate Commerce Act, in that it seeks to prescribe a method of accounting by this interstate carrier, when said Acts of Congress have delegated the power to prescribe said accounting to the Interstate Commerce Commission and the said Commission has prescribed and directed that this plaintiff and other interstate carriers keep their accounts in accordance with the methods so prescribed by it.

11. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the State of North Carolina, by its tax laws, permits the counties, cities, towns, townships and special taxing districts to levy taxes on the assessed value of plaintiff's property known as an ad valorem tax, which is based upon the whole property of plaintiff, tangible and intangible, and to this the tax laws of the State add a so-called franchise tax of one-tenth of one per cent. on the same assessed value and by the statutes hereinbefore referred to, the Legislature of North Carolina has levied and unless restrained the defendants in this action

140 will undertake to collect an additional tax characterized as an income tax of three per cent on plaintiff's net operating revenue, including revenue derived from interstate commerce, and plaintiff avers that this system of pyramiding taxes and the entire scheme of taxation amounts to a regulation of commerce between the states, because necessarily a tax of one-tenth of one per cent upon the tangible and intangible property of this plaintiff and a tax of three per cent upon its net operating revenue, including revenue derived from interstate commerce, are taxes upon interstate commerce, the property, tangible and intangible, having already been taxed at its full value, and plaintiff shows that this scheme of taxation levies a tax and burden upon the interstate commerce of plaintiff and violates the Commerce Clause of the Constitution of the United States, Section 8 of Article 1.

12. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the penalties imposed for failure to comply with the Income Tax Act enacted by the Legislature of North Carolina are so excessive as to be violative of plaintiff's rights under the Constitution of the United States.

13. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void because the plaintiff has no adequate remedy at law.

14. In failing to hold that the plaintiff is entitled to the injunction as prayed for in the bill of complaint, for that the income tax attempted to be imposed upon plaintiff by the Income Tax Act of 1921 enacted by the Legislature of North Carolina is void for that the levying of the income tax casts a cloud upon plaintiff's title.

W. M. HENDREN,
Attorney for Plaintiff.

Stipulation of Counsel as to Record.

Filed Dec. 13, 1922.

In the District Court of the United States for the Eastern District
of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.*Stipulation of Counsel as to Record.*It is stipulated and agreed by and between the parties to the above
entitled cause:That the Clerk, in making up the transcript of record on this
appeal from the decree of the District Court shall include:

Bill of complaint and exhibits thereto.

Application for interlocutory injunction.

Order on application for interlocutory injunction.

Notice of hearing on application for interlocutory injunction.

Answer.

Affidavit of J. H. Bridgers with exhibits.

Affidavit of Nathan O'Berry.

Affidavit of C. D. Bradham.

Affidavit of A. R. Turnbull.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of J. C. Nelms.

Affidavit of F. C. Harding.

Affidavit of J. B. Duke.

Affidavit of M. S. Hawkins.

Affidavit of E. H. Kemper.

Affidavit of O. S. Thompson.

Affidavit of A. J. Maxwell.

Affidavit of R. O. Self.

Testimony and exhibits.

Certificate of Corporation Commission as to certain lumber cor-
porations, and others licensed as common carriers and engaged in
intrastate commerce in North Carolina.

Notice of appeal.

Petition for appeal.

Appeal bond.

Assignments of error.

Order allowing appeal and granting supersedeas and stay bond.
Citation.

Decree.

Stipulation of Counsel.

Agreement as to order setting down the case for hearing on merits.

Tender of amount admitted to be due and declination of the Commissioner of Revenue to receive the same.

Order of Judge granting thirty days' temporary stay, bearing date November 17, 1922.

It is further stipulated that the Clerk may use in preparing the record on appeal printed copies of all such pleadings, documents, affidavits, etc., as may be furnished by the parties hereto.

W. M. HENDREN,
Attorney for Complainant.
JAMES S. MANNING,
Solicitor for Defendants.

142 *Memorandum of Original Papers Certified Separately.*

Petition for Appeal filed December 13, 1922.

Appeal allowed Dec. 13, 1922.

Appeal Bond dated Dec. 13, 1922; penalty, \$1,000.00: Obligors: Southern Railway Company and United States Fidelity & Guaranty Company of Baltimore, Maryland: Conditioned for damages and costs.

Citation dated Dec. 13th, 1922; service accepted by James S. Manning, of Counsel for Defendants, Dec. 13th, 1922.

143 *Order to Transmit Record.*

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

And thereupon it is ordered by the Court here that a transcript of the record and proceedings in said suit be transmitted to the United States Supreme Court at Washington, D. C., and the same is transmitted accordingly.

S. A. ASHE,
Clerk United States District Court.

Clerk's Certificate.

In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY

vs.

A. D. WATTS, Commissioner of Revenue, et als.

I, S. A. Ashe, Clerk, United States District Court, for the Eastern District of North Carolina, do hereby certify that the foregoing pages present a full, true and correct copy of the proceedings had and orders entered in that certain suit in equity pending in said Court, wherein Southern Railway Company is complainant and A. D. Watts, Commissioner of Revenue of North Carolina, and others, are defendants.

In testimony whereof, I have hereunto set my hand and affixed the seal of the said District Court at the Courthouse in Raleigh, State of North Carolina, this 20th day of December, 1922.

[Seal United States District Court, Eastern Dist. of N. C. at Raleigh.]

S. A. ASHE,

Clerk United States District Court.

145 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et als,
Defendants.

Petition for Appeal and Stay.

To the Honorable H. G. Connor, District Judge of the United States for the Eastern District of North Carolina:

The Southern Railway Company, the above named plaintiff, feeling aggrieved by the order of the Court entered in the above entitled cause on the 13th day of November, 1922, refusing and denying the

injunction applied for in this cause restraining the defendants from collecting the income tax assessed against the plaintiff, hereby appeals to the Supreme Court of the United States from the said order upon the grounds set forth in the assignments of error filed herewith, and plaintiff prays that its appeal be allowed and that citation be issued as provided by law and that a transcript of the record, proceedings and documents upon which said appeal is based, duly authenticated, be sent to the Supreme Court of the United States under the rules of such Court in such cases made and provided.

And plaintiff further prays that the Court enter an order staying the collection of the said income tax and staying further proceedings by the defendants until the appeal herein prayed for shall have been heard, passed upon and disposed of by the Supreme Court of the United States.

SOUTHERN RAILWAY COMPANY,
By WM. HENDREN,
Attorney.

146 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Petition for appeal and stay. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

147 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.,
Defendants.

Order Allowing Appeal and Granting Supersedeas and Stay.

This cause coming on to be heard upon the application of complainant, Southern Railway Company, for an appeal to the Supreme Court of the United States, and for a supersedeas and order staying and restraining the collection of the income tax involved in this suit and alleged to be illegal in the complaint filed herein, until the determination of the appeal in this cause now pending in the Supreme Court of the United States, and complainant being represented by W. M. Hendren, its attorney, and the defendants by their attorneys, Frank Nash, Assistant Attorney General of North Carolina, and George H. Brown, the appeal prayed for is hereby granted, appeal bond in the sum of \$1,000.00 to be filed.

And the Court being of the opinion that the status quo between the parties should be preserved pending such determination of appeal by the complainant to the Supreme Court of the United States:

It is, therefore, decreed and adjudged that defendants, their agents, servants and employees and each of them be and are hereby restrained from collecting or attempting to collect from complainant the income tax which is the subject matter of this suit, pending the determination of the appeal by the complainant in this cause now pending in the United States Supreme Court.

It is further ordered and decreed that complainant do give bond, bond, with good and sufficient surety, in the sum of \$10,000.00, to be approved by the Judge of the United States Court, or the Clerk of said Court, conditioned to pay to said defendants all of such income tax that may finally be determined in this cause to be legally due and payable by the complainant to the defendants.

Dated this 13 day of December, 1922.

H. G. CONNOR,

District Judge, Eastern District of North Carolina.

148 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Order allowing Appeal and Granting Supersedeas and Stay. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

149 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Plaintiff,

vs.

A. D. WATTS, Commissioner of Revenue of North Carolina; BENJAMIN R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, Defendants.

the United States of America to A. D. Watts, Commissioner of Revenue of North Carolina; Benjamin R. Lacy, State Treasurer of North Carolina; Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina. Greeting:

Whereas, Southern Railway Company has lately appealed to the Supreme Court of the United States from a decree lately rendered in the District Court of the United States for the Eastern District of North Carolina, made in favor of you, the said Southern Railway Company, having filed the security required by law, you are therefore hereby cited to appear before the said Supreme Court of the

United States, at the City of Washington on the 13th day of January, next, to do and receive what may appertain to justice to be done in the premises.

Given under my hand at the City of Raleigh in the Fourth Circuit, this the 13 day of December, in the year of our Lord, One Thousand, Nine Hundred and Twenty-two.

H. G. CONNER,
*Judge of the District Court of the
United States for the Eastern
District of North Carolina.*

Service accepted this 13 day of December, 1922.

JAMES S. MANNING,
Of Counsel for Defendants.

150 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Citation & Acceptance of Service. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

151 In the District Court of the United States for the Eastern District of North Carolina.

In Equity.

No. 449.

SOUTHERN RAILWAY COMPANY, Complainant,
vs.

A. D. WATTS, Commissioner of Revenue of North Carolina, et al.

Know all men by these presents that Southern Railway Company, as principal, and United States Fidelity & Guaranty Company of Baltimore, Maryland, as surety, acknowledge themselves indebted to the defendants, A. D. Watts, Commissioner of Revenue of North Carolina, Benjamin R. Lacy, State Treasurer of North Carolina, Baxter Durham, State Auditor of North Carolina, and James S. Manning, Attorney General of North Carolina, in the above entitled cause in the sum of One Thousand (\$1,000.00) Dollars, to the payment of which we bind ourselves, our successors and assigns.

In witness whereof, Southern Railway Company, principal, has caused these presents to be executed by W. M. Hendren, its Attorney, and United States Fidelity & Guaranty Company of Baltimore, Maryland, the surety, has caused these presents to be executed by W. B. Jones, its Attorney in Fact, duly appointed and authorized to execute surety bonds, and its corporate seal to be hereto affixed.

The condition of the foregoing bond is such that:

Whereas, Southern Railway Company, the above named plaintiff, instituted a suit in the United States District Court for the Eastern

District of North Carolina against A. D. Watts, and other defendants named in said bill, in which said cause a permanent injunction was asked to be granted against the defendants, enjoining the collection of the income tax claimed to be due the State of North Carolina as set out in said bill upon the grounds as set forth in said bill; and,

Whereas, upon the hearing of said application for a permanent injunction, the prayer of the plaintiff was denied and the bill dismissed; and,

Whereas, the plaintiff has obtained an appeal to the Supreme Court of the United States and a citation has been issued to the defendants citing and admonishing them to be and appear in the Supreme Court of the United States on January 13th, 1923.

Now, the condition of the above obligation is such that, if the said Southern Railway Company shall prosecute its appeal to effect and answer all damages and costs if it fail to make its plea good, then the above obligation to be void; else to remain in full force and effect.

In Witness Whereof, Southern Railway Company, principal, has caused these presents to be executed by W. M. Hendren, its Attorney and United States Fidelity & Guaranty Company of Baltimore, Maryland, Surety, has caused these presents to be executed by W. B. Jones, its Attorney in Fact, thereunto duly authorized and empowered so to do, and its corporate seal to be hereto affixed, this the 13 day of December, 1922.

SOUTHERN RAILWAY COMPANY,
By W. M. HENDREN,

Its Attorney.

UNITED STATES FIDELITY &
GUARANTY COMPANY, OF BAL-
TIMORE, MARYLAND,

By WM. B. JONES,
Attorney in Fact.

[Seal of the United States Fidelity & Guaranty Company.]

Approved:

H. G. CONNOR,

*Judge of the United States District
Court for the Eastern District of
North Carolina.*

153 [Endorsed:] In Equity. No. 449. Southern Railway Company vs. A. D. Watts, Commissioner of Revenue of North Carolina, et als. Appeal Bond. I certify that the within is entered and filed this day. Dec. 13, 1922. S. A. Ashe, Clerk.

Endorsed on cover: File No. 29306. E. North Carolina D. C. U. S. Term No. 756. Southern Railway Company, Appellant, vs. A. D. Watts, and A. D. Watts as Commissioner of Revenue of the State of North Carolina, et al. Filed December 22d, 1922. File No. 29306.

(8285)

FILED

JAN 9 1923

WM. R. STANSBURY
CLERK

IN THE
SUPREME COURT OF THE UNITED STATES.

No. 756.

SOUTHERN RAILWAY CO.

vs.

A. D. WATTS, COMMISSIONER OF REVENUE OF NORTH
CAROLINA, ET ALS.

No. 727.

NORFOLK SOUTHERN R. R. CO.

vs.

SAME.

No. 724.

ATLANTIC COAST LINE R. R. CO.

vs.

SAME.

No. 744.

SEABOARD AIR LINE R. R. CO.

vs.

SAME.

Then come the defendants, representing the State of North Carolina and move this Honorable Supreme Court:

That the above causes, now docketed and being at issue in this court be advanced and set down for argument at as early a date as is convenient to the court.

These causes involve a different subject-matter from those between same parties, decisions in which were handed down on January 2, 1923, by this court.

These cases involved the validity of the franchise and *ad valorem* property taxes levied by the State of North Carolina. The cases now before the court and sought to be advanced to an early hearing involve the validity of the income taxes levied and assessed against the Plaintiffs, Railroad Companies. This tax was sustained in the lower Federal Court and an appeal taken by Plaintiffs to this court. An injunction or stay pending the appeal has been granted and the State has been unable to collect any part of said income tax for two years past. It is essential to the support and maintenance of the State that these taxes be paid as soon as possible as the State levies no property tax for its support depending on franchise, privilege and income taxes entirely. To delay the hearing of these causes for several years would result in great inconvenience and damage to the State government.

Wherefore your honors are earnestly petitioned to advance these causes and set them down for hearing at a date as early as is consistent with the convenience of the court.

JAS. S. MANNING,

Atty. General State of North Carolina.

GEO. H. BROWN,

Of Counsel.

JANUARY 8, 1923.

[Endorsed:] Southern Ry. Co., Norfolk Southern Ry. Co. and other R. R. Cos. *vs.* A. D. Watts, Comsnr. Revenue of State of North Carolina. Motion to advance.

MAR 19 1923

WM. B. STANSBURY

CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 724.

ATLANTIC COAST LINE RAILROAD COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, Appellant,

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 727.

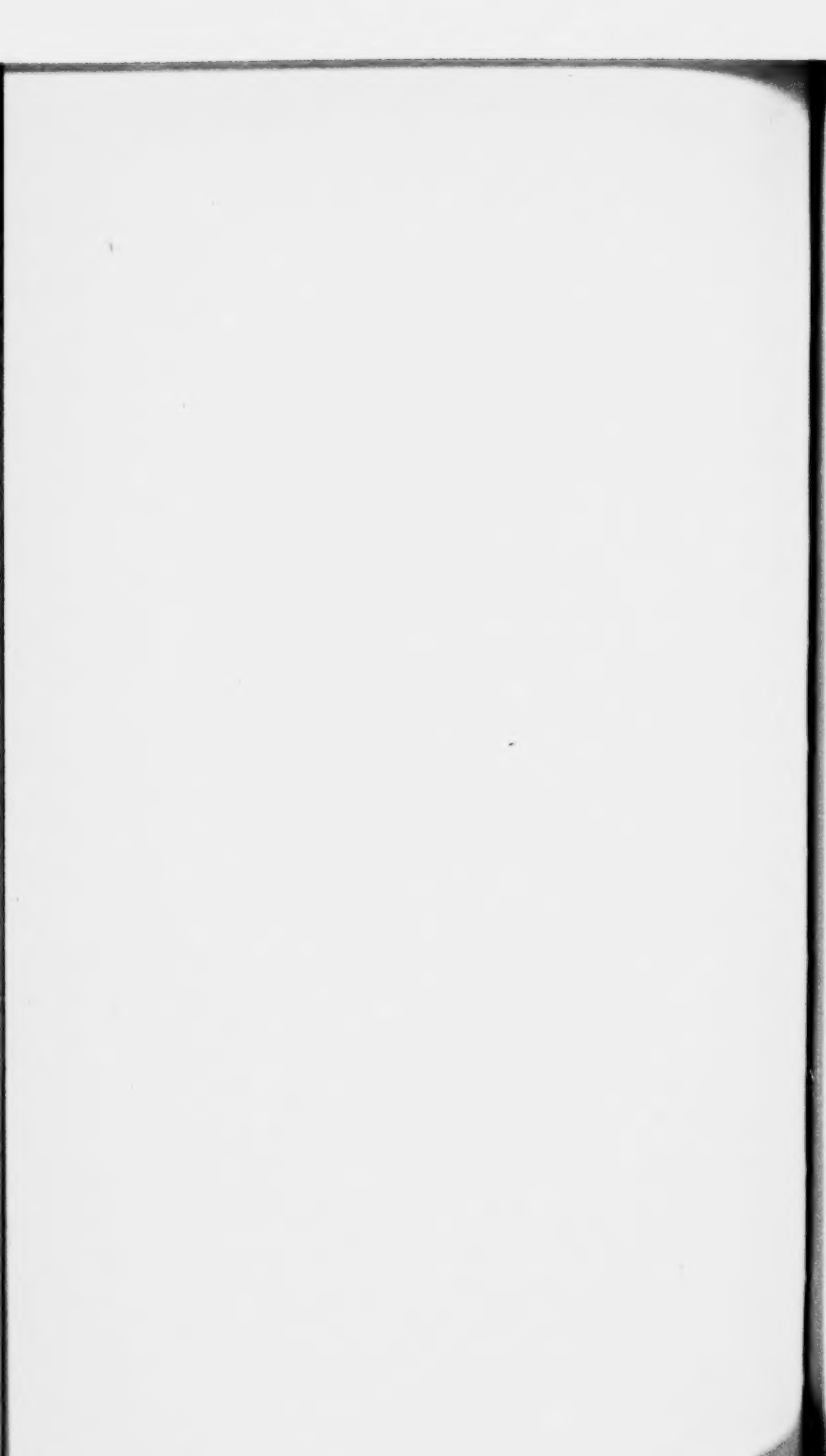
NORFOLK SOUTHERN RAILROAD COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

**Brief of Appellants in Support of Motion to Sub-
stitute R. A. Doughton, Commissioner of Reve-
nue of North Carolina, for A. D. Watts, Commis-
sioner of Revenue of North Carolina.**

S. R. PRINCE,
THOS. W. DAVIS,
JAMES F. WRIGHT,
W. B. RODMAN,
MURRAY ALLEN,
Counsel for Appellant.



IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 724.

ATLANTIC COAST LINE RAILROAD COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 744.

SEABOARD AIR LINE RAILWAY COMPANY, Appellant,

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

No. 727.

NORFOLK SOUTHERN RAILROAD COMPANY, Appellant

vs.

A. D. WATTS, Individually and as Commissioner of Revenue
of North Carolina, et al., Appellees.

**Brief of Appellants in Support of Motion to Sub-
stitute R. A. Doughton, Commissioner of Reve-
nue of North Carolina, for A. D. Watts, Commis-
sioner of Revenue of North Carolina.**

This is a suit to enjoin public officers of North
Carolina from enforcing the Income Tax Act of
North Carolina and to have the Income Tax Act
of North Carolina decreed invalid for the reasons

assigned. One of the original defendants was A. D. Watts, at that time Commissioner of Revenue of North Carolina, and the other defendant was and is James S. Manning, Attorney General of North Carolina. As shown by the motion to substitute, A. D. Watts resigned the office of Commissioner of Revenue on January 29, 1923, and on the same day his successor, R. A. Doughton, was appointed and confirmed. The prayer of the motion, consented to by R. A. Doughton, is to substitute R. A. Doughton, Commissioner of Revenue, for A. D. Watts, Commissioner of Revenue.

This Court, in the recent cases of "*Gorham Manufacturing Company vs. Wendell, et al.*" (decided February 19, 1923), "*City of Boston vs. Jackson*" (decided December 4, 1922), and "*Irwin vs. Wright*," 258 U. S. 219, has stated the rule. It is—

1. Where individuals are sued as members of a Board or Commission having a continuing existence the suit does not abate on retirement of the individuals, but may be continued, substituting their successors in office.

2. A suit to enjoin a public officer from enforcing a statute is personal and, in the absence of a statute, the action abates as to him upon his retirement from office.

3. Where the successor in office consents to the substitution and there is any basis at all under the State law or practice for substitution of successors in office, this Court will avail thereof and permit the substitution.

The Income Tax Act of North Carolina (Chap-

ter 34, p. 203, Public Laws of North Carolina, Session 1921) attacked in this suit, provided for the return to be made to the Tax Commission and for the tax to be paid to the Tax Commission and for the law to be administered by the Tax Commission. The Tax Commission was created by Chapter 38, p. 225 of the Public Laws of North Carolina, Session 1921. The Legislature of North Carolina passed an Act (Chapter 40, p. 288, Public Laws of North Carolina, Session 1921) entitled "An Act to Transfer the Powers and Duties of the State Tax Commission to the State Department of Revenue." This Act provided in Section 1 as follows:

"Section 1. From and after the first day of May, one thousand nine hundred and twenty-one, all the powers and duties imposed by any act or law, including Revenue and Machinery Acts, enacted by the present session of the General Assembly, upon the State Tax Commission, shall be transferred to and imposed upon a department to be known as the State Department of Revenue, created by this act, to be administered by the Commissioner of Revenue, to be appointed as provided in this act. All such powers and duties, except as otherwise provided herein, shall devolve upon the Commissioner of Revenue, and wherever in the revenue laws of the State the words 'State Tax Commission' are used such words shall, after May first, one thousand nine hundred and twenty-one, be held to mean Commissioner of Revenue, except as otherwise provided in this act."

This was the status of the law at the time of the

institution of the suit against A. D. Watts, individually and as Commissioner of Revenue. The Income Tax Act, as originally enacted, was to be administered by the State Tax Commission, but by the later enactment the duties of the State Tax Commission were transferred to the department to be known as the State Department of Revenue, to be administered by the Commissioner of Revenue. We therefore contend that under the status of the legislative enactments of North Carolina above set forth, the Commissioner of Revenue is the administrative officer of the State Department of Revenue, a continuing department, and therefore Watts sued as Commissioner of Revenue comes under the ruling of this Court, above set forth, in which an individual is sued as a member of a Board or Commission. The Department of Revenue has a continuing existence and the retirement of the individual Watts does not abate the suit, but his successor in office, Doughton, may be substituted. A. D. Watts had, of course, no personal interest in the matter. The suit was against him as Commissioner of Revenue because he was the statutory officer directed to enforce what Appellant thought to be an unconstitutional statute. The error complained of was not on account of the exercise of any discretion or judgment on his part, but merely the enforcement of the law as written.

Section 461 of the Consolidated Statutes of North Carolina, 1919, provides:

“Abatement of actions. 1. No action abates

by the death, marriage, or other disability of a party, or by the transfer of any interest therein, if the cause of action survives, or continues. In case of death, except in suits for penalties and for damages merely vindictive, or in case of marriage or other disability of a party, the court, on motion at any time within one year thereafter, or afterwards on a supplemental complaint, may allow the action to be continued, by, or against, his representative or successor in interest. In case of any other transfer of interest, the action shall be continued in the name of the original party, or the court may allow the person to whom the transfer is made to be substituted in the action."

This is in substance the same as the Section of the Arizona Code which this Court had before it in the case of *Irwin v. Wright, supra*, construing which this Court held the substitution could not be made. That ruling would control here unless said statute has been construed by the North Carolina Court or the practice in that State permits such substitution. The Supreme Court of North Carolina has sufficiently ruled on the statute to permit the substitution. We may say, that which we believe will not be contradicted, namely, that the practice is to permit such substitution.

The Supreme Court of North Carolina, in the case of *Davenport v. McKee*, 98 N. C. 500, which was a suit brought by the State on relation of Davenport, Treasurer, against the defendant Sheriff of Gaston County, had before it a contention that

the action had abated by reason of the going out of office of the Treasurer who brought the suit and the induction of a successor in office while it was pending. The Court said:

“The action is brought by the State on bonds executed to it, and the relator is but an agent in seeking to recover the moneys due; and besides, a contingency of a transfer of interest pending a suit is provided for in Section 188 of The Code, which declares how a cause may be continued, except a suit for penalties and vindictive damages, in case of the death, marriage, or other disability of a party, and that ‘in case of any other transfer of interest the action shall be continued in the name of the original party, or the Court may allow the person to whom the transfer is made to be substituted in the action.’ The motion was properly refused.”

Section 188 of the Code referred to in the above quotation is the same as Section 461 of the present Code of North Carolina, above set forth. The case is cited to show that the Court held that the induction of a successor in office was a transfer of interest within the meaning of Section 461. The North Carolina Court having held said Section applies to a successor in office and the Section plainly allowing the action to be continued “*by or against*, his representative or successor in interest” shows that the North Carolina Court would hold Section 461 applied to the kind of case we have in

hand and allow the substitution. This being true, then the general rule announced by this Court applies and the substitution should be allowed because of the State Court's construction of a State statute permitting the same.

Section 505 of the Income Tax Act provides that the tax shall become a debt due the State of North Carolina from the time it is payable. Section 506 provides that action for recovery of the tax may be brought at any time by the Attorney General of the State at the instance of the Tax Commission (now the Commissioner of Revenue) in the name of the State, to recover the amount of any taxes, penalties, and interest due under this Act.

Paragraph 5 of Section 600 provides that "any person who, without fraudulent intent, fails to pay any tax * * * within the time required by or under the provisions of this Act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, in action in any Court of competent jurisdiction."

The Attorney General of North Carolina, upon whom are placed the duties to collect the tax and to prosecute for failure to pay by the above Sections of the Act, is a party defendant to this action, so that at all events the Court below erred in refusing the injunction and dismissing the bill as to the Attorney General, and we submit that the

case can not abate as to him, and for the reasons given above the substitution of R. A. Doughton should be permitted.

Respectfully submitted,

S. R. PRINCE,
THOS. W. DAVIS,
JAMES F. WRIGHT,
W. B. RODMAN,
MURRAY ALLEN,
Counsel for Appellant.

FILED

MAR 19 1923

WM. R. STANSBURY
CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY,
Appellant,
vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Motion for Leave to Substitute R. A. Doughton,
Commissioner of Revenue of North Carolina, for
A. D. Watts, Commissioner of Revenue of North
Carolina.

S. R. PRINCE,
W. M. HENDREN,
Counsel for Appellant.

L. E. JEFFRIES,
Of Counsel.

March 19, 1923.

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY,
Appellant,

vs.

A. D. WATTS, INDIVIDUALLY AND AS
COMMISSIONER OF REVENUE OF
NORTH CAROLINA, ET AL., Appellees.

Comes the Appellant, Southern Railway Company, and moves the Court to substitute R. A. Doughton as one of the Appellees in this cause in place of A. D. Watts, and, for grounds of said motion, respectfully shows:

A. D. Watts, individually and as Commissioner of Revenue of the State of North Carolina, together with James S. Manning, Attorney General of North Carolina, were the original defendants herein. A. D. Watts resigned the office of Com-

missioner of Revenue on January 29, 1923, and was on January 29, 1923, succeeded in office by R. A. Doughton, who now holds said office.

Wherefore, Appellant prays that R. A. Doughton be substituted for A. D. Watts.

S. R. PRINCE,
Attorney for Appellant.

The undersigned, James S. Manning, Attorney General of the State of North Carolina, and representing R. A. Doughton, the present Commissioner of Revenue of North Carolina, consents for said R. A. Doughton to the substitution hereinabove moved for.

JAMES S. MANNING,
Attorney for R. A. Doughton.

MAR 23 1923

W. M. B. STANBURY

CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, *Appellant*

vs.

A. D. WATTS, ET AL., *Appellees.*

INCOME TAX SUIT.

BRIEF FOR APPELLANT.

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March 10, 1923.

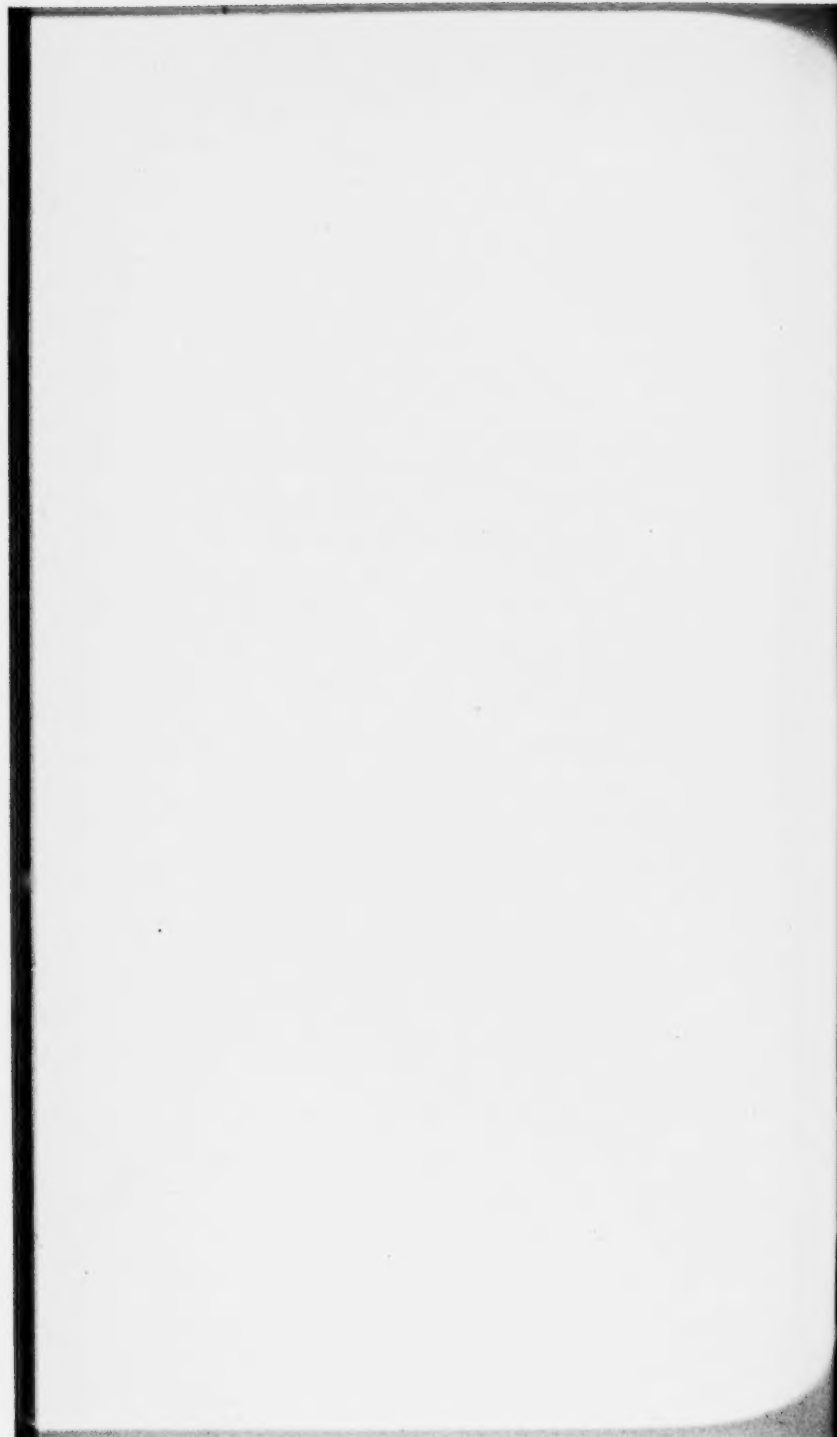


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IN THE
Supreme Court of the United States

OCTOBER TERM, 1922.

No. 756.

SOUTHERN RAILWAY COMPANY, *Appellant*
vs.

A. D. WATTS, ET AL., *Appellees.*

BRIEF FOR APPELLANT.

STATEMENT OF THE CASE

This is a suit by a Virginia corporation against certain income tax levying, collecting, and enforcing officers of the State of North Carolina. The amount involved is fifty-seven thousand dollars. In this suit the construction of the Constitution of the United States is in question and the case is before this Court on direct appeal under Section 238 of the Judicial Code from a final decree of the District Court of the Eastern District of North Carolina dismissing the bill, without opinion.

Article 5, Section 3, of the Constitution of North Carolina (record, page 2) provides that the General Assembly may tax net incomes. Under this authority, the Legislature of North Carolina at its regular Session, 1921, enacted an Income Tax Law (Chapter 34, Public Laws of North Carolina,

1921), levying a tax of three per cent on the entire net income of all corporations. This Income Tax Law in Section 101 states the purpose of the law to be to impose a tax upon net income. Section 201 is the specific Section dealing with the income tax on railroads (4). This latter Section was amended by Chapter 35 of the Public Laws of 1921. Section 306 of the Income Tax Act (5) set forth the deductions allowed in computing net income. This Section did not apply to railroads.

Section 202 and the amendment (Chapter 35, Public Laws, 1921) provides that railway corporations in the class of complainant, required to keep accounts according to the Standard Classification of Accounting of the Interstate Commerce Commission, shall first arrive at gross operating revenue within the State, including an equal mileage porportion within the State of its interstate business, and from this gross revenue shall deduct the following items:

- (1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.
- (2) Uncollectible revenue.
- (3) Taxes paid in North Carolina for the income year, other than income taxes and war profits and excess profits taxes.
- (4) An equal mileage proportion of car hire.

“and the balance shall be deemed to be their net income taxable under this Act.”

The Commissioner of Revenue sent to Appellant

a form for the making out of this return (14) and claimed and demanded a tax under the law, as shown by said form, amounting to \$71,522.06. The Railway claimed that this tax was not levied on its true net income, in that under the Standard Classification of Accounts, promulgated by the Interstate Commerce Commission, in order to arrive at net income, the following deductions from its gross income should be made, in addition to those set forth in Section 202, namely:

- Equipment Rents (including Car Hire, Rent of Locomotives, Rent of Passenger Cars, etc.);
- Joint Facility Rents;
- Rent for Leased Roads;
- Miscellaneous Rents;
- Separately Operated Properties—Loss;
- Interest on Funded Debt;
- Interest on Unfunded Debt;
- Amortization of Discount on Funded Debt;
- Maintenance of Investment Organization;
- Income Transferred to Other Companies;
- Miscellaneous Income Charges.

Making said deductions according to the Classification of Accounts of the Interstate Commerce Commission, and as set forth in the bill (15), showed that the tax on the net income would be \$16,641.73. Appellant claimed further that the Interstate Commerce Commission permitted other deductions, as set forth in Exhibit "C" to the bill (15-16), which would make the income tax on net income \$13,703.95. A return on that basis was

tendered the Commissioner of Revenue, within the sixty days extension allowed from the initial due date, and declined by him (82-3). The further material facts will appear later in this brief.

There was an application filed for an interlocutory injunction (16). This did not come to a hearing, it being agreed that no action would be taken seeking to enforce the collection pending the litigation, as a result of which an order was entered setting the case down for final hearing on its merits (18). The case was heard on the answer, affidavits, and testimony and the Court entered final decree dismissing the bill (87 to 93). The appeal is from this decree.

The assignment of errors is found in the record, pages 95 to 99. The assignments of error insisted upon are numbered 2, 4, 5, 8, 9 and 10, which, in substance, raise the following questions of invalidity of the law.

(1) The tax is on a part of the gross income from interstate commerce and violates the Commerce Clause of the Federal Constitution and Section 3, Article 5, of the North Carolina Constitution, which empowers the State to tax only *net* income.

(2) The Law is void because it contains an unreasonable classification upon no fair substantial difference, and its enforcement denies Appellant the equal protection of the law guaranteed it under the Fourteenth Amendment to the Constitution of the United States and the Uniformity Section of the North Carolina Constitution.

(3) The State has the power to tax only net income from interstate commerce, as defined by the Interstate Act, as amended.

BRIEF.

Jurisdiction.

This suit, between citizens of different States, involving in excess of three thousand dollars, and raising in good faith the construction of the Commerce Clause of the Constitution of the United States and the Fourteenth Amendment to the Constitution of the United States, and the non-payment of the income tax creating a lien upon the property of the Appellant and subjecting the property to execution and sale, and subjecting Appellant to heavy penalties for non-payment, gives the Federal Equity Court jurisdiction unless there was a plain, adequate remedy at law.

Wallace v. Hines, 253 U. S. 66-67;
Shaffer v. Carter, 252 U. S. 37, 46;
Greene v. L. & I. R. R., 244 U. S. 499, 506;
Union Pac. v. Colorado, 247 U. S. 282, 286;
Southern Railway v. Watts, decided Jan. 2, 1923.

There is no plain, adequate, complete remedy at law.

The case of *Shaffer v. Carter* was a suit in equity to restrain the enforcement of a tax assessed under the Income Tax Law of Oklahoma. The Court said:

“As ground for resorting to equity, the bill alleges that plaintiff is the owner of various oil and gas mining leases covering lands in Creek County, Oklahoma, and that the lien assessed thereon by virtue of the levy and tax warrant creates a cloud upon his title. This entitles him to bring suit in equity (citing many cases), unless the contention that he has a plain, adequate, and complete remedy at law be well founded.”

Shaffer v. Carter, 252 U. S. 37, 46.

The Income Tax Act provides in part:

“Sec. 403. *Time and place of filing returns.* Returns shall be in such forms as the Tax Commission may from time to time prescribe and shall be filed with the Tax Commission, at its main office or at any branch office which it may establish, on or before the fifteenth day of March in each year,” etc.

It further provides for payment at the time of filing of the return:

“Sec. 500. *Time and place of payment of tax.* 1. The full amount of the tax payable, as the same shall appear from the face of the return, shall be paid to the Tax Commission at the office where the return is filed at the time fixed by law for filing the return,” etc.

The method of collection of the tax in case of non-payment is found in Section 504:

“Sec. 504. *Warrant for the collection of taxes.* If any tax imposed by this act or any

portion of such tax be not paid within sixty days after the same becomes due, the Tax Commission shall issue an order under its hand and official seal directed to the sheriff of any county of the State, commanding him to levy upon and sell the real and personal property of the taxpayer, found within his county, for the payment of the amount thereof, with the added penalties, interest and the cost of executing the same and to return to the Tax Commission the money collected by virtue thereof by a time to be therein specified, not less than sixty days from the date of the order. The said sheriff shall thereupon proceed upon the same in all respects, with like effect, and in the same manner prescribed by law in respect to executions issued against property upon judgments of a court of record and shall be entitled to the same fees for his service in executing the order, to be collected in the same manner. If an order be returned not satisfied in full, the Tax Commission shall have the same remedies to enforce the claim for taxes against the taxpayer as if the State had recovered judgment against the taxpayer for the amount of the tax."

Among the penalties provided is that found in Section 600. Paragraph 2 of this Section reads as follows:

"If any taxpayer fails voluntarily to file a return of income or pay a tax, if one is due, within sixty days of the time required by or under the provisions of this act, the tax shall be doubled, and such doubled tax shall be increased by one per cent for each month or

fraction of a month from the time the tax was originally due to the date of payment."

The penalty for neglect without fraudulent intent is found in paragraph 5 of Section 600 and is as follows:

"Any person who, without fraudulent intent, fails to pay any tax or to make, render, sign or verify any return, or to supply any information, within the time required by or under the provisions of this act, shall be liable to a penalty of not more than one thousand dollars, to be recovered by the Attorney General, in the name of the people, by action in any court of competent jurisdiction."

Under the head of revision and appeal, the Income Tax Law provides:

"Sec. 700. *Revision by Tax Commission.* A taxpayer may apply to the Tax Commission for revision of the tax assessed against him, at any time within one year from the time of the filing of the return or from the date of the notice of the assessment of any additional tax. The Tax Commission shall grant a hearing thereon, and if, upon such hearing, it shall determine that the tax is excessive or incorrect, it shall resettle the same according to the law and the facts and adjust the computation of tax accordingly. The Tax Commission shall notify the taxpayer of its determination and shall refund to the taxpayer the amount, if any, paid in excess of the tax found by it to be due. If the taxpayer has failed, without good cause, to file a return within the time pre-

scribed by law, or has filed a fraudulent return, or, having filed an incorrect return, has failed, after notice, to file a proper return, the Tax Commission shall not reduce the tax below double the amount for which the taxpayer is found to be properly assessed.

“Sec. 701. *Appeal.* Any taxpayer may file formal exceptions to any finding by the State Tax Commission with respect to his taxable income, and upon such exceptions being overruled, any such taxpayer shall have the right, upon the payment of the amount of tax found by the State Tax Commission to be due, and upon filing bond for costs in the sum of two hundred dollars, to have the record in such case certified to the Superior Court of the county in which the taxpayer resides, or has his principal place of business, within thirty days after notice by the Tax Commission of its determination, given as provided in section 700 of this act. Thereupon, appropriate proceedings shall be had and the relief, if any, to which the taxpayer may be found entitled may be granted and any taxes, interest or penalties paid, found by the Court to be in excess of those legally assessed, shall be ordered refunded to the taxpayer, with interest from time of payment.”

The Legislature further provided by Special Act of December 19, 1921, for the refund of illegally collected taxes as follows:

“Section 1. Whenever taxes of any kind are or have been through clerical error, or mis-

interpretation of the law, or otherwise, collected and paid into the State Treasury in excess of the amount legally due the State, the State Auditor shall issue his warrant for the amount so illegally collected, to the person entitled thereto, upon certificate of the head of the department through which said taxes were collected or his successor in the performance of the functions of that department, with the approval of the Attorney-General, and the Treasurer shall pay the same out of any funds in the treasury not otherwise appropriated: Provided, demand is made for the correction of such error or errors within two years from the time of such payment: Provided further, that claims which have arisen within the five years next preceding the ratification of this act shall be presented and made within two years from the ratification of this act."

In considering whether the foregoing provides a plain, complete, and adequate remedy at law, we should consider also Section 7979 of the Consolidated Statutes of North Carolina, which is a subsection under the general statutes of North Carolina dealing with the collection of taxes. That Section provides in part:

"7979. *Remedy of taxpayer for unauthorized tax.* Unless a tax or assessment, or some part thereof, be illegal or invalid, or be levied or assessed for an illegal or unauthorized purpose, no injunction shall be granted by any court or judge to restrain the collection thereof in whole or in part, nor to restrain the sale of any property for the nonpayment thereof;"

Said Section also provided for payment under protest and demand within thirty days and suit thereafter against the County.

The North Carolina Supreme Court had before it in the case of *Range Company v. Carver* an application for an injunction to restrain a sheriff from collecting a tax. The defendant denied plaintiff's right to proceed by injunction under Section 76 of the Machinery Act of 1895, now Section 7979. The Court did not agree with defendant that an injunction would not lie and held:

"It was agreed that plaintiff might proceed by injunction, unless he is prevented by this section, and it is true that this section does not profess to prohibit the issuance of injunctions against the collection of public taxes, except in certain cases, and it seems to us that the exception is about as broad as the prohibition, and about all the effect it has is to give an additional remedy, which is left to the discretion of the party to pay the tax and then bring an action to recover the money back. But whether the exception is as broad as it seems to us or not, it in express terms excepts from the inhibition of injunction taxes that are 'illegal or invalid,' and that is what the plaintiff alleges in this case—that they are 'illegal and invalid'; and this question of jurisdiction being disposed of, the matter comes to be considered upon its merits."

Range Co. v. Carver, 118 N. C. 328, at 330.

The North Carolina Supreme Court in the case of *Purnell v. Page*, 133 N. C. 125, in considering

the question of whether an injunction would lie to restrain the collection of an income tax under a former law, held at page 129:

“As to the other point, whether the plaintiff can maintain an injunction against the sale of his property under an illegal tax, or must pay the tax under protest and sue to recover it back, it is equally well settled that he can pursue either remedy. *Range Co. v. Carver*, 118 N. C., 331; *Armstrong v. Stedman*, 130 N. C. 217; *Brinkley v. Smith*, 130 N. C. 224, hold that under the language of the statute ‘injunctive relief may be invoked by a taxpayer when the tax is *invalid or illegal*.’ ”

The foregoing North Carolina cases are cited to show that under the general policy of the State of North Carolina and its decisions a taxpayer is allowed his election of remedies. He may either pay under protest and sue to recover or he may enjoin the collection of a tax, if it be claimed to be non-collectible due to its illegality or invalidity.

The general rule, as set forth in the *Carter* case, *supra*, is that the remedy at law must be plain, adequate and complete. In order to oust the equity jurisdiction, the remedy must be as practical and as efficient to the ends of justice and its prompt administration as the remedy in equity. This Court, in the case of *Gormley v. Clark*, 134 U. S. 338, stated the rule to be:

“The jurisdiction in equity attaches unless the legal remedy, both in respect to the final

relief and the mode of obtaining it, is as efficient as the remedy which equity would afford under the same circumstances, *Kilbourn v. Sunderland*, 130 U. S. 505, 514;''

That statement of the rule has been concurred in by the Supreme Court of North Carolina in the case of *Sumner v. Staton*, 151 N. C. 198, 201.

It will be noted from the foregoing Sections of the Income Tax Act that the tax is payable at the time and place of making the return and that if not paid then under Section 504 the Tax Commission (now the Commissioner of Revenue) may direct the Sheriff to levy and sell the property of the taxpayer in the manner prescribed by law in respect to executions upon a judgment. It is not clear that this procedure may not be had even though the taxpayer asks a revision of his tax under Section 700. The legal remedy must be certain and plain. There must be no doubt about it. We submit there is serious doubt as to whether Sections 700 and 701 apply to a case of this kind, where the law is claimed to be unconstitutional. An analysis of Sections 700 and 701, we think, will convince that they were not intended to apply to a claim of the invalidity of a tax upon constitutional grounds because—

(1) Of the anomaly of submitting to an administrative officer of the State a constitutional question arising out of the want of power of the State to levy a tax;

(2) The sections on their face are applicable

only to cases where the tax has been erroneously assessed or calculated. The application is "for revision of the tax" and the relief to be granted is to "resettle the same" if the tax is found to be "excessive or incorrect."

There is likewise room for the contention that the Act of the Special Session of 1921 was not intended to nor does it qualify the right given under Section 7979 of the Consolidated Statutes to enjoin the enforcement of a tax alleged to be void for constitutional reasons. The language of this statute can be fulfilled by limiting its scope and purpose to be to supply a remedy where a tax payable to the State is assessed because of a "clerical error or misinterpretation of the law."

Unless the words "or otherwise" makes this statute applicable to a tax claimed to be void upon constitutional grounds, it is clear that this statute does not afford the plaintiff any remedy at all. Is it not a permissible construction to say that the words "or otherwise" mean something that is akin to "clerical error or misinterpretation of the law"?

The tax in this case is claimed to be void, so there is nothing due at all. There can then be no "excess" of an amount legally due the State.

That the draftsman of this Act did not have in mind a case where the tax is asserted to be void in toto appears from the language of the proviso limiting the time within which remedy given by the statute shall be availed of.

It would seem that the remedy is limited to "the

correction of such error or errors," that is, errors arising out of a miscalculation or a misinterpretation of the law, or some other mistake of like nature.

Even though it should be determined that this statute plainly covers the case at bar, we still submit it does not measure up to the requirements of an adequate remedy at law for the reason that the Treasurer is not required to refund the tax unconditionally, but only when there are funds in the Treasury not otherwise appropriated.

So that a taxpayer pursuing this remedy can have his demand for repayment fully met by the statement of the Treasurer that there are no unappropriated funds, and it can be said without the slightest disrespect or disloyalty that such condition is apt to prevail with respect to the Treasury of the State of North Carolina in the light of the rapid progress that is being made by this State in various public improvements.

An argument is not needed to establish that promised action by the Attorney General, however sincere and reasonably sure of fulfillment, is not a "legal remedy."

But, aside from the foregoing, the plaintiff is entitled to its remedy in equity, because under the Statutes of North Carolina, income tax is a lien upon all of the property of the taxpayer and it, therefore, casts a cloud upon the title of the property that is not assessed or involved, and this fact alone gives a court of equity jurisdiction.

Shaffer v. Carter, 252 U. S. 48.

The foregoing contention is not foreclosed by the decision of this Court in *Keokuk & Hamilton Bridge Company v. Salm, et al.*, 258 U. S. 122, for many reasons. In that case the Court pointed out that the payment of the tax was *not* by distraint or levy, but by legal proceedings. The contrary is true here. In that case the Court had under consideration an invalidity which consisted wholly of a claim of discriminatory overvaluation. In this case we have a claim of unconstitutionality on several grounds and a claim of a cloud cast upon the title. In this case we have also the general policy of the State to permit an injunction in the matter of invalid taxes. Such policy was wholly absent in the Bridge case.

The contention that Appellant may pay and sue to recover is not an adequate remedy at law.

King v. Northern Pacific, 196 Fed. 323, 325.

Where a person is entitled to litigate in a Federal Court, it is not an adequate remedy at law to be invited into a State Court by his antagonist to adjudicate his rights.

U. S. Life Ins. Co. v. Cable, 98 Fed. 761, 763.

A State cannot tie up a citizen of another State, for property rights within its territory invaded by unauthorized acts of its own officers, to suits for redress in its own courts.

Smyth v. Ames, 169 U. S. 466, 517.

The North Carolina Income Tax Law is Void under the Commerce Clause of the Federal Constitution.

A State income tax law levied in part upon *gross* income or earnings from interstate commerce is a direct burden upon interstate commerce contrary to the Commerce Clause of the Federal Constitution.

Galveston, etc., Ry. v. Texas, 210 U. S. 217, 227;

U. S. Glue Co. v. Oak Creek, 247 U. S. 321;

Shaffer v. Carter, 252 U. S. 37, 57;

Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 120;

Crew Levick Co. v. Pennsylvania, 245 U. S. 292, 297.

The North Carolina law taxes in part the *gross* income from interstate commerce of Appellant in that it does not permit the deduction from gross of the accounts denominated by the Interstate Commerce Commission Classification as follows:

"No. 537—Rent for Locomotives."

"No. 538—Rent for Passenger Train Cars."

"No. 541—Joint Facility Rents."

"No. 542—Rent for Leased Roads."

"No. 547—Interest on Unfunded Debt."

"No. 621—Miscellaneous Debits" (bad debts written off during year in North Carolina).

A State income tax law is unconstitutional and violates the Fourteenth Amendment to the Constitution of the United States if the classification provided therein is unreasonable, arbitrary, discriminatory, and without reasonable basis.

Royster Guano Co. v. Virginia, 253 U. S. 412, 415;

Gulf, Colorado & Santa Fe v. Ellis, 165 U. S. 150, 156;

Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 121;

Shaffer v. Carter, 252 U. S. 37, 58.

The classification in the North Carolina Income Tax Law renders it invalid under the above decisions in that—

Under Section 306 individuals and other corporations are permitted to deduct from gross income in arriving at the “net income” to be taxed:

(a) “2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade or property to which the taxpayer has not taken or is not taking title or in which he has no equity.”

and Appellant and other railroads which keep their accounts according to the Standard Classification of Accounts prescribed by the Interstate Commerce Commission are not allowed similar deductions.

(b) “3. All interest paid during the income year on indebtedness except interest on ob-

ligations contracted for the purchase of non-taxable securities. Dividends on preferred stock shall not be deducted as interest."

and Appellant is not allowed to make a like deduction.

(c) "7. Debts ascertained to be worthless and charged off within the income year if the amount has previously been included in gross income in a return under this act."

Appellant is not allowed a like deduction. It is allowed to deduct the item "Uncollectible Revenue," but that as per Standard Classification of Accounts does not include bad debts written off during the year accrued in North Carolina.

The Income Tax is Unconstitutional in That It Violates the Uniformity Section of the North Carolina Constitution.

The following cases hold that the Uniformity Section applies to this kind of tax, as well as to ad valorem taxation.

State v. Williams, 158 N. C. 610, 613;
Gatlin v. Tarboro, 78 N. C. 119, 121;
Land Co. v. Smith, 151 N. C. 70, 75.

And in the particulars set out under above item of this brief the classification is arbitrary and unreasonable.

A State's Statutory Definition of What Constitutes "Net Income" of an Interstate Railroad Whose Gross is Derived in Large Part from Interstate Commerce Cannot Legally Include as a Part of Such Net Income Any Item Prescribed by the Interstate Commerce Commission's Classification of Accounts to be Deducted from Gross Income before Arriving at Net Income.

ARGUMENT.

To a large extent the difference between counsel in this cause does not lie in any statement of the well established principles of law as set forth in the decisions of this Court, but is in the application of those principles to the facts of this case.

This Court has repeatedly announced that in determining whether a State tax violates the Federal Constitution, it will be governed by its judgment of the actual operation and effect of the law in each case.

Crew Levick v. Pennsylvania, 245 U. S. 292, 294;

American Manufacturing Co. v. St. Louis, 250 U. S. 459, 463;

Shaffer v. Carter, 252 U. S. 37, 55.

It must be admitted that the State has not the power to tax gross income from interstate commerce, such tax being void as a direct burden thereon, as distinguished from a remote and incidental burden.

The North Carolina Constitution correctly limits the income tax to net income and the legislative act in words taxes net income, but we contend that the Legislature cannot by its fiat, make that net income which is not in fact net, but is composed in

part of gross income. If this is not true, a State may by the device of definition nullify the protection given gross revenue from interstate commerce by the Commerce Clause of the Constitution.

What Is Net Income?

This Court, in the case of *DeGanay v. Lederer*, wherein was involved the validity of the Income Tax Act of Congress as applied to income from securities of a citizen of France, held by a domestic company on property owned in the United States, in passing upon the meaning of the term "property," restated the general rule of interpretation:

"Unless the contrary appears, statutory words are presumed to be used in their ordinary and usual sense, and with the meaning commonly attributable to them."

DeGanay v. Lederer, 250 U. S. 376, 381.

The term "net income" in its usual and ordinary sense means that income which is left after deducting from gross earnings the expense of producing such earnings. It means what is left, if anything, after you have squared accounts, the outgo vs. the intake, not including capital charges. If that is a correct definition, the question is narrowed to what items of expense may properly be considered as incurred in producing the gross earnings.

Appellant says, for illustration, that if it pays out money for the rent of a locomotive or a passenger car (52) that such rental payments are a natural ordinary expense to be deducted from the

earnings produced by those locomotives and cars before you arrive at the net. This common sense proposition is backed up by the Standard Classification of Accounts of the Interstate Commerce Commission, which permits such deductions. The State recognized the principle when it permitted by amendment to the law the deduction of "car hire." That account under the standard classification prescribed to be followed by the State, includes freight cars only. Why deduct rental of freight cars and refuse to deduct rental of passenger cars?

The term "net income" has been defined in a general way by this Court. In the case of *Union Pacific v. U. S.*, the Court had to determine what constituted net earnings under an Act of Congress which obligated the Railway to pay the Government up to a certain period five per cent of the net earnings. The Court said:

"Having considered the question of receipts or earnings, the next thing in order is the expenditures which are properly chargeable against the gross earnings in order to arrive at the 'net earnings,' as this expression is to be understood within the meaning of the act. As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves. It may often be difficult to draw a precise line between expenditures for

construction, and the ordinary expenses incident to operating and maintaining the road and works of a railroad company. Theoretically, the expenses chargeable to earnings include the general expenses of keeping up the organization of the company, and all expenses incurred in operating the works and keeping them in good condition and repair; whilst expenses chargeable to capital include those which are incurred in the original construction of the works and in the subsequent enlargement and improvement thereof."

Union Pacific v. United States, 99 U. S. 402, 420.

It is proper, however, to call attention to the fact that the Court in that case excluded from "net earnings," as contemplated by the Act of Congress, interest on bonded debt of the company, saying that that item should be charged to capital interest account and not to current expenditures.

This Court, in the case of *Peck v. Lowe*, 247 U. S. 165, had before it the question of the validity of a tax upon the entire net income, the controversy being over so much of the tax as was attributable to the income from shipping to foreign countries. The Court, through Mr. Justice Van Deventer, held that there was no discrimination and that the objection against the tax was not well grounded, and said:

"The tax is levied after exportation is completed, after all expenses are paid and losses

adjusted, and after the recipient of the income is free to use it as he chooses."

Applying that definition of net income to this case it is found that all expenses have not been paid and "losses adjusted." The record shows that item "No. 621—Miscellaneous Debits" is not permitted to be deducted and that the item contained (15) bad debts written off during the year accrued in North Carolina in the sum of \$26,196.97 (62). Until that deduction is made, all losses have not been adjusted and the net has not been reached, and the Appellant is not free to use it as he chooses until the expense of earning it, including the above loss, has been paid.

The Lowe case was followed in the case of *U. S. Glue Co. v. Oak Creek*, which called attention to the fact that the tax was on only net receipts after all expenses were paid and losses adjusted and the recipient of the income was free to use it as he chose, and said:

"A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large."

U. S. Glue Co. v. Oak Creek, 247 U. S. 321, 329.

What items of deduction from gross to arrive at true net has the State failed to allow? The

answer to this question will have to come from the record. As set forth in the statement of facts, the State deducts from gross revenue the following items:

(1) Proportionate average of operating expenses, as shown by the Interstate Commerce Commission Standard Classification of Accounts.

(2) Uncollectible revenue.

(3) Taxes paid in North Carolina for the income year other than income taxes and war profits and excess profits taxes.

(4) An equal mileage proportion of "car hire."

Attention is again directed to the fact that the North Carolina Law permits deduction of "car hire," while the Interstate Commerce Commission's Classification, under the general head of "Equipment Rents," permits deduction not only of car hire, but items 536 to 540, as set out on record, page 58, being:

Account No. 537.	Rent for Locomotives.
" " 538.	Rent for Passenger Cars.
" " 539.	Rent for Floating Equipment.
" " 540.	Rent for Work Equipment.

which would mean that instead of, as shown on Exhibit "A" (14), deducting for account of car

hire the debit balance of \$589,386.05, there should have been deducted the sum of \$596,348.84 (15).

The State does not permit any deduction of the following items:

“541. Joint Facility Rents, \$213,767.07.” (15)

These rents are the cost of trackage in North Carolina and the payment for use of certain terminals in North Carolina (53). If this deduction of joint facility rents is made there should be included on the income side revenue which came to the Railway under Account No.:

“508. Joint Facility Rent Income, \$66,886.47.”

The State does not permit any deduction of item—

“542. Rent for Leased Roads, \$591,491.75.” (15)

The record, at pages 59 to 61, shows that the rents sought to be deducted are for the rental of roads or parts of roads in North Carolina and the earnings which are taxed are derived in part from said roads. It is stated that said rent for leased roads does not escape taxation because the roads to which this rental is paid were assessed and paid to North Carolina an income tax based on this rental received. It is further pointed out that the question of whether or not any rental should be de-

ducted is determined in the law itself in Section 306, paragraph 2, which prescribes the deductions allowed individuals and private corporations, and which reads as follows:

"2. Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The State does not allow as a deduction interest on unfunded debt, which is allowed by the Interstate Commerce Commission's Classification under item—

"547. Interest on Unfunded Debt, \$116,-151.96."

Arguments may be advanced for the classification of railroads different from an individual and not allowing deduction of interest on funded debt, which for this company amounted to \$1,481,-391.58. (15)

Such arguments we believe to be wholly unsound, but at least there is no such difference or distinction between interest on borrowed money of an individual, which is permitted as a deduction, and interest on the unfunded debt of a railroad.

Is the Classification Arbitrary?

The power of the State to classify is undoubted so long as the classification is not unreasonable and

is founded on some fair and substantial ground of difference.

Royster Guano Co. v. Virginia, 253 U. S. 412, 415.

We respectfully submit that while entirely legal to put all railroads in a class separate from individuals and corporations generally, it is invalid classification to permit individuals and corporations to make the following deductions, among others, and not permit like deductions to railroads, viz.:

(1) Under Section 306, paragraph 2, individuals are allowed to deduct:

“Rentals or other payments required to be made as a condition of the continued use or possession, for the purposes of the trade, of property to which the taxpayer has not taken or is not taking the title or in which he has no equity.”

Appellant contends there is no reasonable basis for allowing such rental deduction to individuals and corporations generally and denying to it the deduction of Joint Facility Rents, amounting to \$213,767.07. Attention is directed that this account for trackage rights, joint depots in North Carolina, etc., is separate and distinct from “Rent of Leased Roads.”

(2) Section 306, paragraph 3, allows other corporations a deduction of interest paid during year on indebtedness, while such deduction is denied

Appellant. The record shows (62) there are two accounts under Interstate Commerce Commission's Classification:

546. Interest on Funded Debt.

547. Interest on Unfunded Debt.

and that Appellant paid in the year \$1,481,391.58 interest on funded debt and \$116,151.96 interest on unfunded debt, neither of which deductions are allowed. The showing is (85) that there are many industrial corporations doing business in North Carolina taxed under this law which have very large mortgage debts and are allowed deduction of interest thereon, for example:

American Agricultural Chemical Company:

Common stock.....	\$33,322,126
Preferred stock.....	28,455,200
First mortgage bonds.....	6,252,000
1st ref. mortgage s. f. gold bonds, Series "A"	30,000,000

American Sugar Refining Company:

Common stock.....	45,000,000
Preferred stock.....	45,000,000
15-year gold bonds.....	30,000,000

American Tobacco Company:

Common stock "A".....	40,242,400
Common stock "B".....	49,344,200
Preferred stock.....	52,699,700
Gold bonds.....	371,950
Gold bonds and cons. Tobacco Collateral Trust Mortgage Bonds.....	1,365,300
Series of gold notes.....	10,000,000
8 per cent dividend certificates.....	8,058,834

Du Pont, I. E., de Nemours & Company:

Common stock.....	63,378,300
Debenture stock.....	71,243,250
10-year gold bonds.....	35,000,000

Galena Signal Oil Company:	
Common stock.....	16,000,000
Preferred stock.....	2,000,000
New preferred stock.....	4,000,000
Convertible debenture.....	6,000,000
Entire stock of subsidiary companies....	2,800,000
Galena Signal Oil of Texas bonds.....	2,800,000
General Electric Company:	
Common stock.....	176,329,100
Debenture for Sprague Stock.....	2,047,000
Debenture	15,136,500
Debenture bonds.....	15,000,000
Kelly Springfield Tire Company:	
Common stock	9,096,002
Preferred stock.....	3,137,100
Second preferred.....	5,625,200
10-year s. f. gold notes.....	10,000,000
Morris Company:	
1st mortgage	17,626,000
10-year s. f. gold notes.....	15,000,000
Wm. F. Mosser Co. 10-year s. f. notes..	3,000,000
Swift & Company:	
Common stock.....	150,000,000
1st mortgage s. f. gold bonds.....	28,923,500
Gold notes.....	65,000,000
Texas Company:	
Stock	164,450,000
3-year s. f. notes.....	22,772,000

If there be anything in the claim that such mortgage bond interest is more properly a capital charge, which we earnestly deny, we fail to see why there is any fair ground of difference between interest on such bonded indebtedness of other corporations and like bonded indebtedness of Appellant.

(3) Under Section 306, paragraphs 6 and 7, individuals and corporations generally are permitted to deduct losses sustained during the year and debts ascertained to be worthless and charged off.

The record shows that Appellant and other railroads are allowed to deduct "uncollectible revenue" as per Standard Classification of Accounts of the Interstate Commerce Commission. This appears on the form sent to Appellant by the Commissioner of Revenue and on the form is a note that the accounts stated in the form are according to the Standard Classification of Accounts. Uncollectible revenue is transportation receipts, such as freight not paid.

The Interstate Commerce Commission has another classification (621. Miscellaneous Debits) to which account is charged bad debts written off, other than purely transportation receipts, and on page 15 of the Record it is shown that Appellant had in the year \$26,196.97 of such debts in North Carolina (62). We can find no reasonable basis for the difference in treatment in this respect.

The State Should, in Taxing Net Income of an Interstate Carrier Derived from Interstate Transportation, Allow the Deductions permitted by the Interstate Commerce Commission in its Standard Classification of Accounts.

In the case of *Kansas City Southern v. United States*, 231 U. S. 423, there was involved a claim of invalidity of the regulations of the Interstate Commerce Commission relative to the method of keeping accounts of interstate carriers. The Court quoted from and referred to the *Union Pacific Case*, in the 99th U. S., and the case of *I. C. v. Interstate Commerce Commission*, 206 U. S. 441, and said:

"In both cases it was recognized that in so complicated a matter as the construction, maintenance, and operation of a railroad line, it is difficult to define and perhaps more difficult to consistently apply a precise distinction between capital and expense accounts; and while the propriety of distributing improvement costs over a series of years was recognized, the impossibility of scientific accuracy in that regard was acknowledged. The question now is, whether the regulations of the Commission under attack do violence to these general principles—rather, it is whether those regulations are so clearly contrary to these and other applicable principles that they should be set aside as being in excess of the powers conferred by Congress upon the Commission."

Kansas City Southern v. United States, 231 U. S. 423, 447.

Accordingly it upheld the regulations of the Commission. The Court also said:

"So far as the profits of past operations have not been distributed to the stockholders, they are represented in the profit and loss account, and therefore such an abandonment or depreciation is properly chargeable to that account unless a special depreciation account has been established in anticipation of such abandonments; and for such an account, provision is made in the regulations."

In the case of *I. C. C. v. Goodrich Transit Co.*,

224 U. S. 194, the Court, in dealing with the meaning of Section 20 of the Interstate Commerce Act, which is the Section that empowers the Commission to require the interstate carriers to keep a uniform system of accounts, said at page 215:

"In Section 20 Congress has authorized the Commission to require annual reports. The act itself prescribes in detail what those reports shall contain. The Commission is permitted, in its discretion, to require a uniform system of accounting, and to prohibit other methods of accounting than those which the Commission may prescribe. In other words, Congress has laid down general rules for the guidance of the Commission, leaving to it merely the carrying out of details in the exercise of the power so conferred. This, we think, is not a delegation of legislative authority."

Again, at page 216:

"Bookkeeping, it is said, is not interstate commerce. True, it is not. But bookkeeping may and ought to show how a business which, in part at least, is interstate commerce, is carried on, in order that the Commission, charged with the duty of making reasonable rates and prohibiting unfair and unreasonable ones, may know the nature and extent of the business of the corporation, the cost of its interstate transactions and otherwise to inform itself so as to enable it to properly regulate the matters which are within its authority."

It further held, at page 211:

“We think this section contains ample authority for the Commission to require a system of accounting as provided in its orders and a report in the form shown to have been required by the order of the Commission.”

Again, this Court in the case of *Kansas City Southern v. United States*, 231 U. S. 423, upheld the power of the Commission to prescribe the method of accounting of an interstate railroad, and on page 442 said:

“Congress, in authorizing the Commission to prescribe a uniform system of accounts, recognized that accounting systems were not then uniform; and in reiterating this authorization in 1906, and adding a prohibition against the keeping of other accounts than those prescribed, manifested a purpose to standardize and render uniform the accounts of the different carriers with respect to matters that entered into property and the improvements thereof, on the one hand, and the current operations of the company, on the other. By the very terms of Section 20, Congress at least outlined the classification of the carriers’ accounts, for it required the annual reports to show ‘the amount of capital stock issued, the amounts paid therefor, and the manner of payment for the same . . . the surplus fund, if any, . . . the funded and floating debts, . . . the cost and value of the carrier’s property, franchises and equipments; . . . the amounts expended for

improvements each year, how expended, and the character of such improvements; the earnings and receipts from each branch of business and from all sources; the operating and other expenses; the balances of profit and loss; and a complete exhibit of the financial operations of the carrier each year including an annual balance sheet.' "

The foregoing decisions show that in certain cases the classification of the Commission has been under fire and been sustained and that the Court upheld the power of the Commission to prescribe the method of accounting.

We go one step further: The Transportation Act, in enlarging the powers of the Commission and in providing what net railway operating income would be considered a fair return upon the value of the Railway, defined that term in Section 15(a) as follows:

" * * * and the term 'net railway operating income' means railway operating income, including in the computation thereof debits and credits arising from equipment rents and joint facility rents."

It will be noted that Congress has said that net railway operating income should include joint facility rents as a debit or a credit as the case might be. We contend that "net railway operating income" is a term used before arriving at "net income" and that there are many credits and debits to be accounted for before net income is arrived at

but at least it shows that Congress determined that in considering net operating income, joint facility rents should be included. The Income Tax Act of North Carolina, as has been previously shown, does not include such equipment rents or joint facility rents. The State, in the Income Tax Act, in a measure recognized the Standard Classification of Accounts of the Interstate Commerce Commission. The trouble is that it did not follow throughout that classification, with the result that the tax in part rests upon gross income from interstate commerce, which the State may not constitutionally tax.

The case comes down to this: The State contends that it is within the power of the Legislature to define "net income." We deny this, in so far as concerns the State's power to define net income when derived from interstate commerce if the State's definition leaves in as net any part of the gross. If the State had the power to tax the gross income from interstate commerce the State, subject to uniformity, would be allowed to define by legislative act what deductions may be made in arriving at the "net" to be taxed, for the reason that it is by legislative favor that the State excludes any part from taxation; but when taxing income from interstate commerce it is by favor of the Constitution of the United States, as interpreted by this Court, that the State may tax any part of interstate revenue, and, therefore, it is entirely reasonable to say that the Interstate Commerce Commission, the governmental agency, should say what shall

constitute the deductions before the "net" is reached which the State may tax. Hence we say that the Interstate Commerce Commission's Classification should not be departed from. If the State of North Carolina can exclude from the deductions from gross, and thereby include in the sum to be taxed as net, any one item which should properly, under the Interstate Commerce Commission's Classification, be deducted from gross or which should be deducted in any proper accounting before arriving at net income, then the State has violated the Commerce Clause of the Federal Constitution and the Uniformity Clause of the State Constitution, and what it has done differs in degree only from a case where it would tax all of the gross. It is true the State has denominated the sum it taxes as net, but that cannot be the sole guide. If one State has the right then the other thirteen States through which Appellant runs have an equal right and the practical result would be that a material part of the gross income from interstate transportation would be taxed.

The North Carolina Income Tax Act, in Article I, provides in part:

"Except as otherwise provided in this act the purpose is to conform to the definitions of income in the revenue laws of the United States Government and regulations made under its authority, in so far as they apply."

The Federal Income Tax Act permits all of the deductions herein claimed before the "net income"

taxed thereunder is arrived at. It is submitted that since Congress has provided a standard, which follows the Interstate Commerce Commission Classification of Accounts, for the sake of uniformity, in so far as revenue from interstate commerce is concerned, the several States should follow that plan. Income Tax Acts are being enacted by many of the States, and for each of the thirteen through which Appellant operates to have a different method would lead to confusion and unfairness.

There is set forth on pages 73 to 81 of the record a statement of the "General Accounts" and "Primary Accounts" prescribed by the Commission for "Operating Revenue" and "Operating Expenses," also a statement (79) of the "Income Accounts" credit and debit. There is attached hereto, marked Exhibits A and B, the form in which the Commission prescribes that the accounts be rendered. These forms merely put in statement form what is shown on record pages 73 to 81. To save expense, these forms (62) (Exhibit 3 to E. H. Kemper's testimony) were not copied in the record because the record pages 73 to 81 already contained the facts.

If Exhibit A is referred to and compared with the form (14) prescribed by the Income Tax Law, it will be seen that the State calls net income that which the Interstate Commerce Commission denominates "Railway Operating Income," with the exception that the State does not allow the deduction of equipment rents and joint facility rents.

The State has not considered at all the income statement, as prescribed by the Interstate Commerce Commission, as set forth on Exhibit B. As construed by the Interstate Commerce Commission, the whole story is not told when we arrive at railway operating income, and therefore it provides that there shall be added certain non-operating income which gives a "total gross income." From this they make "deductions from gross income" with the final result of a figure which is called "net income."

It is submitted that when seeking to ascertain the net income, there must be deducted all of the expense of earning such income and that such deductions should not be confined to the actual or purely "operating expenses" as that term is usually understood but should include all expense necessarily incident to the conduct of the business and the bringing in of the revenue, other than capital expenditure. We therefore say that the State stopped short of net income, and the law is unconstitutional.

Respectfully submitted,

S. R. PRINCE,
W. M. HENDREN,
Counsel for Appellant.

L. E. JEFFRIES,
Of Counsel.

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COMPARATIVE REPORT OF REVENUES AND EXPENSES

Months of _____ 192__ and 192__ and _____ Months Ended _____ 192__ and 192__

	MONTH THIS YEAR	MONTH LAST YEAR	INCREASE OR DECREASE	PER CENT.	PERIOD THIS YEAR	PERIOD LAST YEAR	INCREASE OR DECREASE	PER CENT.
MILES OF ROAD OPERATED	_____ MILES	_____ MILES	_____ MILES		_____ MILES	_____ MILES	_____ MILES	
OPERATING REVENUES								
Freight								
Passenger								
Mail								
Express								
All other Transportation								
Incidental								
Joint facility—Cr.								
Joint facility—Dr.								
RAILWAY OPERATING REVENUES								
OPERATING EXPENSES:								
Maintenance of Way and Structures								
Maintenance of Equipment								
Traffic								
Transportation								
Miscellaneous Operations								
General								
Transportation for Investment—Cr.								
RAILWAY OPERATING EXPENSES								
NET REVENUE FROM RAILWAY OPERATIONS								
Ratio of Operating Expenses to Operating Revenues								
Ratio of Transportation Expenses to Operating Revenues								
Railway Tax Accruals								
Uncollectible Railway Revenues								
TOTAL EXPENSES, TAXES AND U. R. REVENUES								
Ratio to Operating Revenues								
RAILWAY OPERATING INCOME								

APPROXIMATE INCOME STATEMENT

Month of 192 and 19 and Months Ended 192 and 19

LIST OF ACCOUNTS	MONTH THIS YEAR	MONTH LAST YEAR	INCREASE OR DECREASE	PERIOD THIS YEAR	PERIOD LAST YEAR	INCREASE OR DECREASE
TOTAL OPERATING INCOME						
NON-OPERATING INCOME:						
Income from Lease of Road						
Miscellaneous Rent Income						
Miscellaneous Non-operating Physical Property						
Separately Operated Properties—Profit						
Dividend Income						
Income from Funded Securities						
Income from Unfunded Securities and Accounts						
Income from Sinking and Other Reserve Funds						
Release of Premiums on Funded Debt						
Contributions from Other Companies						
Miscellaneous Income						
TOTAL NON-OPERATING INCOME						
TOTAL GROSS INCOME						
DEDUCTIONS FROM GROSS INCOME:						
Rent for Leased Roads						
Miscellaneous Rents						
Miscellaneous Tax Accruals						
Separately Operated Properties—Loss						
Interest on Funded Debt						
Interest on Equipment Obligations						
Interest on Unfunded Debt						
Amortization of Discount on Funded Debt						
Maintenance of Investment Organization						
Income Transferred to Other Companies						
Miscellaneous Income Charges						
Dividend on Southern Ry.—M. & O. Stock Trust Cfs						
TOTAL DEDUCTIONS						
NET INCOME						
DISPOSITION OF NET INCOME:						
Income applied to Sinking and Other Reserve Funds						
Dividend Appropriations of Income						
Income Appropriated for Additions and Betterments						



No. 756

THE SOUTHERN RAILWAY COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 724

ATLANTIC COAST LINE RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 727

NORFOLK SOUTHERN RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

No. 744

SEABORD AIRLINE RAILROAD COMPANY, *Appellant,*
vs.

A. D. WATTS,
Commissioner of Revenue for North Carolina

**ARGUMENT OF GEO. H. BROWN
FOR DEFENDANT APPELLEE**

GEORGE H. BROWN,
of Counsel for Defendants.

These suits in Equity were brought to enjoin the collection of an income tax imposed under Constitution of North Carolina by the Legislature upon the net incomes of Plaintiffs for year 1921. There was no interlocutory injunction. The cases were heard upon final hearing by Connor, District Judge in Eastern District of North Carolina. The Court rendered judgment for Defendant, dismissing the bills and Plaintiffs appealed.

The Defendant earnestly contends that the suits cannot be maintained under the well settled principle that equity will not interfere where the Plaintiff has an adequate remedy at law.

The income tax Statutes, Public Laws of 1921, Sect. 701, etc., (all fully cited in defendants' brief), gives an adequate remedy to any person or Corporation complaining of unlawful or erroneous assessment of income tax by appeal from Tax Commission to Superior Court, thence to State Supreme Court. The judgment of the latter Court can be reviewed on writ of error by this Court. To give full effect to this very full remedy at Special Session, 1921, the Legislature provided for prompt repayment of such tax adjudged to be improperly collected.

I ask the Court to examine carefully the part of defendants' brief where the Statutes and decided cases of this Court are cited and quoted from.

The sums involved are not so large that the State can possibly have difficulty in promptly refunding them. Consequently there cannot be any irreparable damage inflicted by remitting plaintiffs to their remedy at law.

In addition to well settled principles of equity announced in numerous decisions of this Court, Section

267 of Judicial Code of U. S. says:

"Suits in equity shall not be sustained in any Court of the United States in any case where a plain, adequate and complete remedy may be had at law."

The remedy provided by the Statutes of North Carolina is plain, adequate and complete. It could not be more so. We think this principle of equity set forth in the Judicial Code should be certainly enforced in cases affecting State taxation. The Statute applies not alone to Railroad Corporations, but to all Corporations and individuals.

The plaintiffs set up seven objections to the validity of this tax, all of which are set out and considered in defendants' brief. I will discuss only a few.

It is contended that this tax is levied upon the gross income of plaintiffs and not on net income and that it constitutes a direct burden on Interstate Commerce in violation of the Federal Constitution.

I will ask Your Honors to bear in mind the principle set out in very many decisions of this Court that an Act of a State Legislature will not be declared void unless its violation of the Federal Constitution is clear, complete and unmistakable, and, (as said in *Railroad Co. vs. Powers*, 201 U. S., 245), "especially is this true when the Statute is one affecting the revenues of the State and therefore of public interest."

It is well settled by decisions of this Court, cited in our brief, that an income tax may be levied by a State on net incomes of Corporations engaged in interstate commerce earned within the State, and that such tax is not

a burden on interstate commerce although the net incomes taxed may be derived in part or mainly from interstate business.

I call Your Honors' attention to two recent cases:

Glue Co. *vs.* Oak Creek, 247 U. S., 31.

Underwood Co. *vs.* Chamberlain, 254 U. S., 113—
cited in our brief.

We earnestly insist that the Statute upon its face purports to tax only the net income of plaintiffs on business done in North Carolina and that if the computation is made as directed therein only such net income is taxed. Section 202 reads:

"The basis of ascertaining the net income of (the plaintiffs) . . . shall be . . . their net income within this State shall be ascertained by taking their gross 'operating revenues' within the State, including . . . the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' (so ascertained) the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission Standard Classification of Accounts."

A mathematical calculation made according to the Statute gives a result which is denominated therein the net operating income of the Railroad Company.

It is seen that under this Statute all of the operating expenses allowed by the Interstate Commerce Commission are to be deducted from the gross revenues. Then

the Statute authorizes other specific deductions from the net operating income in order to produce the taxable net income. The language of the Statute is plain:

“From the net operating income thus ascertained shall be deducted ‘uncollectible revenue’ (in other words, losses or bad debts) and taxes paid in this State for the income year, other than income taxes and war profits and excess-profits taxes, and *the balance* shall be deemed to be their net income taxable under this act.”

The plaintiffs have filed as exhibits the regulations of the Commerce Commission as to Standard Classification of Accounts. Reference to these will show the completeness of detail with which every conceivable operating expense is allowed. All of these items are allowed plaintiffs as deductions by the North Carolina Statute. Many expenses are included not allowed under the income tax law of North Carolina to other classes of tax payers, either individuals or Corporations, such as purchase of tools and small equipment which are allowed as expenses to Railroads under this classification, but which are considered as invested capital in case of other taxpayers. The very large item of money paid by Railroads in satisfaction of judgments for tools is allowed as deductions. This item is not allowed under North Carolina Statute to other taxpayers. All amounts paid out as insurance premiums for all kinds of insurance, storm casualty, fire, etc., are allowed as deductions to those Public Service Corporations keeping the standard classification of accounts and not allowed other taxpayers.

A general summary of these various and very numer-

ous items allowed on deductions to Railroads is attached to answers in these cases as Exhibit A.

It seems to me that an examination of the State income Statute, taken in connection with the standard classification of accounts and the specific deductions allowed in addition by the Statute, will disclose plainly that the net income only of plaintiffs is subjected to taxation and that that is all that has been taxed.

It is contended that there is an illegal and unjust discrimination made against plaintiffs and in favor of individuals and other smaller Corporations doing manufacturing and other kinds of business.

It is claimed that this discrimination consists in failure to allow plaintiffs deduction from their gross income of rental money paid out for leased lines of Railroads. Also in failure to allow deduction for interest paid out on their bonded indebtedness.

This brings me to consider the question of classification for purposes of taxation.

The Railroads in North Carolina have been put for purposes of taxation in one class and it must be admitted that as between those Corporations, whether foreign or local, there is no discrimination. They are all treated alike and fed out of the same spoon.

I contend that the classification complained of is upon a practicable and reasonable basis and is no such arbitrary and unjust discrimination as is prohibited by the Fourteenth Amendment or the uniformity clause of the State Constitution.

The Fourteenth Amendment prescribes no rigid rule of equality, but leaves to the sound discretion of the States of the Union a wide latitude in classifying all

kinds of business and occupations whether conducted by individuals or Corporations, foreign or domestic, for the purpose of government. If such classification is practical and not confiscatory or manifestly arbitrary, it is valid and will not be reviewed or disturbed by this Court.

Railroad Company *vs.* Pennsylvania, 134 U. S., 232, and other cases cited in defendants' brief.

This principle is always applied very liberally by this Court when the classification is made by the State in the exercise of its powers of taxation. This Court is always very loth to interfere with the workings of the State Government in its attempts to raise revenue for its support.

Connolly *vs.* Sewer Co., 184 U. S., 540, and other cases in defendants' brief.

In this case it is said: "A tax may be imposed only upon certain callings and trades, for when the State exerts its power to tax, it is not bound to tax all pursuits or all property that may be legitimately taxed for governmental purposes. It would be an intolerable burden if a State could not tax any property or calling unless, at some time it taxed all property or all callings. Its discretion in such matters is very great and should be exercised solely with reference to the general welfare as involved in the necessity of taxation for the support of the State. A State may *in its wisdom* classify property for purposes of taxation and the exercise of its discretion is not to be questioned in a Court of the United States so long as the classification does not invade rights secured by the Constitution of the United States."

It is the uniform consensus of all the utterances of this Court on the subject that any classification is per-

missible which has a reasonable relation to some permitted end of governmental action. It is sufficient if the classification is reasonably founded in the purposes and policy of taxation.

This principle is clearly stated by Justice Pitney in the *Royster guano* case, 253 U. S., 412, which is quoted from extensively in *Norfolk Southern* brief. That case says, "The latitude of discretion is notably wide for the purpose of taxation and the granting of partial or total exemptions upon the grounds of policy."

We maintain that the classification of all these great interstate railroads and other Corporations required to keep standard classification accounts in one class, is appropriate and reasonable, not arbitrary and rests upon substantial grounds of public policy in matters of taxation.

In this classification all Corporations similarly situated are treated exactly alike.

This is not a classification that is altogether illusory and made for the purpose of injuring and discriminating against those in the same class and similarly situated, in favor of other taxpayers.

The classification is founded in the very nature of the property classified. This Court has repeatedly recognized the fact that railroads differ so greatly from other property that it is necessary to classify and tax them differently from other property.

This Court has said that it is not only competent to make a separate class of all railroads, but it is competent for the Legislature to make classifications within the general class of railroads.

Savannah Railroad Company vs. Savannah, 198 U. S., 392.

In that case it was held competent for the Legislature to make a separate class for taxation of only those railroad Corporations using City Streets.

This subject of the right of a State to classify property for purposes of taxation is discussed in an interesting opinion by Mr. Justice McKenna, in *Hersler vs. Colliers Co.*, decided March 27, 1922, and the principles of law that are referred to are reasserted and approved. In that case this learned Justice says:

“And so classification has uses in government,—indeed, we may say, necessities in government,—for government as well as persons has purposes, varied and, at times exigent, and its legislation must be accommodated to them, either in convenience or necessity. That government has the power to do so we have often pronounced; not, however, omitting to recognize the restraints upon the power while expressing its range and adaptation. In its exercise in taxation, we have said, it is competent for a State to exempt certain kinds of property and tax others, the restraints upon it only being against ‘clear and hostile discriminations against particular persons and classes.’ Discriminations merely are not inhibited, for it was recognized that there are ‘discriminations which the best interests of society require.’ *Bell’s Gap R. Co. vs. Pennsylvania*, 134 U. S., 232.”

In the opinion in *North Carolina Railroad tax cases* of January 2, 1923, Justice Brandeis says: “Railroads differ in so many respects from other properties that they may, as a class, be taxed differently or additionally, if that is not inconsistent with the Constitution of the State.”

In the recent case of *Durham Service Co. vs. Durham* U. S. Supreme Court, reported March 15, 1923, p. 332, Mr. Justice McReynolds says: "The power of the Legislature to make reasonable classifications and to impose a different burden upon the several classes cannot be denied."

Another interesting opinion on the subject of State taxation is that of Mr. Justice Clark in *Duane vs. Jackson*, 256 U. S., 589. I commend those cases to Your Honors' consideration. They plainly declare, after reviewing the many decisions on the subject, that this Court will not interfere with the States in the matter of taxation and raising revenue unless the Legislation is manifestly confiscatory or destructive of some right guaranteed by the Federal Constitution. Certainly no case of that sort is presented in either of these records.

It is contended that there is an unconstitutional discrimination made against the Railroad Corporations because they are not allowed to deduct from their gross income the rental money paid out for railroad lines leased from other Railroad Corporations.

Also that Railroad Corporations are not permitted to deduct from their gross incomes the interest or their bonded indebtedness, while individuals and minor manufacturing Corporations are permitted to deduct interest on their debts.

Both these contentions I think are covered by the argument that the Legislature has the right to classify Railroad Corporations and put them in a class by themselves because they differ so materially from all other properties.

But I submit that this is not an illusory classification

but is founded in reason and common sense.

The Railroad Company most interested in the rental controversy is the Norfolk Southern. If there is any other, I am not aware of it.

The Norfolk Southern has leased from the State of North Carolina and some private stockholders the Atlantic & North Carolina Railroad for a period of 99 years, paying a stipulated rental and all taxes levied on the Corporation and leased property.

This is very different from the case of a private individual or an ordinary business corporation leasing pieces of property for short periods for use in their business.

That is not a capital expense but an expense incurred in operating a business already established. It is purely and simply an operating expense.

The Norfolk Southern desired to include the Atlantic road in its system. It did not have the cash to buy it out and out and it could not borrow it. So it leased the road for 99 years. This is really a capital expenditure, and is practically a purchase. It certainly is not an operating expense, I submit. It is the same as if it had taken the cash out of the Norfolk Southern treasury and paid for the leased road.

This Court has said that the net income of a Railroad Corporation is the excess of the gross earnings over the expenditures defrayed in producing them, aside from and exclusive of the expenditure of capital laid out in acquiring constructing and equipping the works themselves. *Union Pacific Railroad vs. United States*, 99 U. S., 402. See also *Cyc. 671, Railroad vs. United States*, 231 U. S., 445.

The principal item that all of plaintiffs contend should

be deducted in order to arrive at the taxable net income is interest on their bonded debt. There is no evidence that they have any floating debt.

Plaintiffs contend that failure to allow this is an illegal discrimination against them in favor of individuals and minor business corporations.

This Court has frequently said that it will not close its eyes to well known facts.

It is a part of the history of railroads in this country that they are almost always created and built by the proceeds of bond issues. They do have stock as all Corporations must have, but in the beginning of the enterprise it is very generally, if not always, of but small market value. After the organization of a railroad Corporation and the acquisition of the right of way, the first thing the promoters and incorporators do is to put a mortgage on the property after issuing the stock to themselves. These bond issues are widely advertised in financial centres and frequently sold at attractive prices.

The proceeds are used to build the railroad and to equip it, and these bonds are never paid, but always renewed or paid by another issue. This is the capital that creates the road. The interest on such debt is a capital expense and cannot be reasonably considered an operating expense.

Under the definition of net income as defined by this Court, it is gross income less only the expenses and losses incurred in earning that income. Expenditure incurred for capital, borrowed to create the road and its equipment is of a permanent character and should not be deducted in order to get at the net annual income.

In Black's Law Dictionary, citing 50 Georgia, 350, re-

ferring to net income and net profits it is said :

“This term does not mean what is made over the losses, expenses and interest on the amount invested. It includes the gain that accrues on the investment, after deducting simply the losses and expenses of the business.”

If the builders of a railroad had taken the cash out of their own pockets and put it in the construction of the road they could not charge up dividends as an operating expense. Not having the cash and having to borrow it, I see no reason that they should be allowed to charge up interest on borrowed capital as an operating expense.

The construction bonds of most railroads have very many years to run longer than any other kind of bonds. That is especially true of some of these plaintiffs. To allow them to charge up interest for all this long period as operating expenses would relieve of payment of all income taxes, or very nearly so.

I fail to see any authority cited by plaintiffs which requires that payments of interest on bonded indebtedness and rentals on 99 year leases of subsidiary roads must be deducted from gross income in order to produce that net income which is within the power of the State to tax.

The argument of plaintiffs that Interstate Commerce Commission has made these deductions is of no value. It was done solely for rate making purposes. This has no bearing, that I can see, upon the power of the Legislature, which alone is the question before this Court.

It is contended that the Income Statute of the State is in violation of the Constitution of the State, Art. 5, Sec.

3. This is the article containing the income tax amendment and is set out in full in the brief of the Norfolk Southern Railroad on page 31. I will not copy it again. It simply provides that laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, etc., and all real and personal property according to its true value in money, etc.

In construing this provision of the Constitution before the Income Tax Amendment was added to it, the Supreme Court of North Carolina, in several decisions, decided that the Legislature of the State had power to classify occupations, and other subjects of taxation by statutory enactment and that such classification in Tax Statutes is not in contravention of the rule of uniformity prescribed in the State Constitution when the tax is imposed alike upon all of a class.

Albertson vs. Wallace, 81 N. C., 479.

Bickett vs. Tax Commission, 177 N. C., 433.

Cobb vs. Commissioners, 122 N. C., 307.

State vs. Roberson, 136 N. C., 587.

State vs. Hunt, 129 N. C., 686.

The foregoing ruling of the North Carolina Court was specifically approved by this Court in *Armour Packing*

Co. vs. Lacey, 200 U. S., 226.

This Court, prior to that case, has fully recognized and approved the ruling of State Courts that where the State Constitution, as in North Carolina requires that taxes shall be levied by uniform rule, it is perfectly competent for the State to tax corporations of different characters

in different ways. The uniformity rule only means that all of a class shall be treated alike.

State Railroad Tax Cases, 92 U. S., 575.

It is contended in brief of Norfolk Southern Railroad, p. 32, that there are several small railroads in North Carolina acting as common carriers who are not treated in same way as these plaintiffs. The character of these roads is described in the affidavits referred to on p. 32 of Norfolk Southern brief. They are logging roads, handling logs to the saw mills of the owners of the roads. Such roads nowadays are a necessary part of a saw mill outfit. For convenience sake some of them carry a very limited class of commodities, and this business is very small and done for the neighborhoods' convenience and does not pay the expenses incurred by it. The State Corporation Commission in its construction of the law does not treat them as in same class with the plaintiffs.

Whether for purposes of taxation these log roads come within Sect. 202 of income tax law and are to be taxed in same class as plaintiffs, has never been decided by the State Supreme Court.

These log roads claim they are not in same class and can not be so taxed. The point is not decided in *Stewart vs. Lumber Road*, 143 N. C., 47, cited in Norfolk Southern brief, p. 33, and I submit that case has but little, if any, bearing on this question. At time it was decided the income tax law had never been enacted. I submit that if these log roads have by misconstruction of the law escaped taxation for 1921, the first year our income tax law was in force, the tax can yet be collected. It is no reason why these plaintiffs should escape taxation. It

is not a discrimination within the 14th amendment. The N. C. income statute does not make any discrimination. It is simply, if wrong at all, an erroneous construction of the statute by the Corporation Commission. If plaintiffs are aggrieved they have their remedy, as under our law any tax payer can apply to the State authorities and State Courts to have property subjected to taxation which has inadvertently or intentionally escaped. If plaintiffs feel aggrieved let them apply under State law to have these log roads' income tax corrected. The remedy is open to them.

It is contended in the Atlantic Coast Line brief, p. 54, that the whole scheme of taxation in force in North Carolina is illegal and void because in conflict with the uniformity section of the State Constitution.

This is a very bold assertion, but suppose it were true, it would avail plaintiffs nothing as this Court has often said unless it deprived plaintiffs of some right guaranteed by the Federal Constitution and the said brief fails to point out any part of Federal Constitution that is violated.

But the assertion is without foundation. It is true that the State Constitution declares that "Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise, and also all real and personal property according to its true value in money."

That has been in the Constitution for fifty years. The income tax amendment was adopted in 1920 to that section.

That entire section, with all amendments to it, is set out on p. 31 of Norfolk Southern brief.

State Tax Commissioners, December 20, 1922, Clark C. J. alone dissenting, South Eastern Reporter, February 17, 1923, p. 336. In that case it is held:

The provision of Pub. Laws 1921, c. 34, § 4, that an individual stockholder shall not be required to list for taxation his stock, is not contrary to Const. art. 5, § 3, requiring laws to be passed for the uniform taxation of investments in stocks, in view of the provisions of Pub. Laws, 1921, c. 38, §§ 43, 57, 82, requiring the corporation to report to the Tax Commissioner all elements imparting value to its capital stock and tax such stock through the corporation.

A copy of the opinions in this case was sent to this Court as when the decision was announced last December.

In conclusion, I hope and believe that when Your Honors have given this case the examination you will give it, and which its great importance deserves, you will find no ground upon which to reverse the judgment of the District Court.

GEO. H. BROWN,
of Counsel for Defendants.